

PENSION PLAN UNDERFUNDING

HEARING
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
AND THE
SUBCOMMITTEE ON SOCIAL SECURITY
OF THE
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HOUSE OF REPRESENTATIVES
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PENSION PLAN UNDERFUNDING

TUESDAY, JUNE 24, 1986

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT AND
SUBCOMMITTEE ON SOCIAL SECURITY,
Washington, DC.

The subcommittees met, pursuant to call, at 9:30 a.m., in room 1100, Longworth House Office Building, Hon. J.J. Pickle (chairman of the Subcommittee on Oversight) presiding.

Chairman PICKLE. The subcommittees will come to order. We will ask our guests and staff to take their seats.

Today, the Subcommittees on Oversight and Social Security will conduct the third in our series of hearings examining America's national retirement income policy. This hearing will focus on the underfunding of single-employer private pension plans and its effect on the viability of the Federal Pension Plan Insurance Program.

The foundation of America's private pension system is the Employee Retirement Income Security Act of 1974, ERISA. Under ERISA, we have a combination of regulations promoting sound pension plan funding practices and an insurance program to guarantee payment of at least some benefits when insufficiently funded pension plans terminate.

In recent years, a number of pension plans have terminated with insufficient assets. This has steadily increased the liabilities, and hence the deficit, of the Pension Benefit Guaranty Corporation. Last year, Congress responded to this problem in the Consolidated Omnibus Reconciliation Act of 1985. As part of that legislation, we increased the annual premium from \$2.60 to \$8.50, and we enacted reforms which restricted the ability of terminating pension plans to shift their unfunded liability to the PBGC.

While this legislation temporarily eased the financial pains besetting the PBGC, I am not satisfied that it provided a long-term cure for the problems caused by underfunded pension plans. Today I understand that PBGC still has a deficit of over \$1 billion. I am concerned that we are all facing an endless series of premium increases. Such increases would let PBGC meet its financial obligations, but they would not resolve the real problem. Furthermore, they could undermine support for the entire voluntary defined benefit pension system.

This morning, we will hear from the U.S. General Accounting Office, which, at my request, has investigated the nature of underfunded pension plans and effect of insurance claims caused by un-

derfunded plan terminations. We will also hear from the Internal Revenue Service and the Pension Benefit Guaranty Corporation, the Federal agencies responsible for enforcing the requirements and managing the programs under ERISA.

Finally, we will receive testimony from several invited witnesses from the private sector who will share with us their very practical concerns on how underfunded plans affect employers, workers, and pension plan administration.

The issues which we are examining today go to the very heart of the pension system, a system with accumulated assets in excess of \$1 trillion. The private single-employer defined benefit program directly affects over 30 million plan participants. Such matters demand our careful attention and I thank all of the witnesses for their willingness to help the subcommittees in their investigations.

Before we begin, I would ask whether any other members would care to make any opening remarks.

Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman.

Today, the Subcommittees on Oversight and Social Security consider the underfunding of qualified pension plans, and the effect that the termination of pension plans is having on the Pension Benefit Guaranty Corporation's single-employer termination program.

This is the third joint hearing of the two subcommittees to review our national retirement income policy.

More than a decade ago, the Employee Retirement Income Security Act of 1974 established a minimum funding standard for qualified pension plans and created termination insurance for single and multiemployer defined benefit plans.

Despite the existence of these minimum funding standards, I am informed approximately 1,100 single employer plans have terminated with unfunded liability since the insurance program was first established.

These terminations have resulted in a current insurance program deficit of about \$1.3 billion. I look forward to hearing from the witnesses who will testify today. I believe this hearing will give us a better understanding concerning how the minimum funding standards are actually working, and what additional amendments to the PBGC single employer insurance program are needed.

I share the chairman's concern that we cannot rely on an endless spiral of increased premiums to solve this problem. Thus, the possibility of additional substantive amendments to the single employer program and the minimum funding standards should also be considered.

Chairman PICKLE. Thank you, Mr. Schulze.

Our first witness is Joseph F. Delfico, if that is the correct way to pronounce your name, Associate Director of the Human Resources Division, representing the GAO. Would you identify the two gentlemen with you?

STATEMENT OF JOSEPH F. DELFICO, SENIOR ASSOCIATE DIRECTOR, HUMAN RESOURCES DIVISION, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY LARRY WOOD, GROUP DIRECTOR; PAUL REYNOLDS, ASSIGNMENT MANAGER; CHRISTOPHER DOYLE, PENSION ACTUARY; AND FRANK KOVALAK, EVALUATOR

[The prepared statement begins at p. 57.]

Mr. DELFICO. On my right is Larry Wood, group director; and on my left is Paul Reynolds, assignment manager; and behind me are Christopher Doyle, our pension actuary; and Frank Kovalak, the evaluator in charge of the study we are doing for you.

With your permission I will present my full testimony for the record, and present a brief summary.

Chairman PICKLE. That is satisfactory. If you will hold up just a minute.

Go ahead. Your entire statement will be made a part of the record. If you make reference, say page so-and-so, so we can follow you a little closer.

Mr. DELFICO. Between ERISA's enactment in 1974 and the end of fiscal year 1985, 68,000 Government-insured plans terminated. About 1,100 of these plans, covering about 160,000 insured participants, filed claims against the insurance program administered by the Pension Benefit Guaranty Corporation because they were underfunded; that is, they did not have enough assets to pay guaranteed benefits.

Claims have exceeded premium revenues from ongoing plans, causing the insurance program to operate at a deficit. The program's estimated deficit at September 30, 1985 was \$1.3 billion.

We analyzed the funding status of large single employer plans, 100 or more participants, using the Government's latest and most complete plan data as of November 1985.

We considered a plan to be underfunded if the value of its assets was less than the estimated value of participants' earned benefits. Most of these benefits would have been guaranteed by the insurance program if the plans had terminated.

We found that most plans in 1983 were overfunded, but many were underfunded, and some by large amounts. Of the 14,500 plans reviewed, over 2,300, 16 percent, were underfunded by more than \$18 billion.

These underfunded plans covered almost 4 million, 21 percent, of the 19 million participants. In contrast, over 12,200 plans with 15 million participants were overfunded by about \$87 billion.

We also found that the bulk of the underfunding was concentrated in a relatively few plans. Over 90 percent of the total underfunding was in 275 plans, or 12 percent of all plans, that were underfunded by \$5 million or more each.

Six plans alone had a total of \$7 billion in unfunded benefits. In addition, 1 out of every 5 underfunded plans was less than 50 percent funded.

Plans may be underfunded at termination for various reasons. Some funding methods result in slower asset accumulation than others. Also, minimum contribution requirements are based on the assumption that the plans will continue rather than terminate; and therefore, on assumptions about future conditions affecting

plan assets and benefit liabilities. The plan's actual experience may differ from these assumptions.

Plans may also be underfunded if they terminate before employers make contributions for a particular plan year. Contributions are not required until 8.5 months after a year ends.

Also, the Internal Revenue Service can waive required contributions because of business hardship.

In addition, benefit increases that allow credit for participants' past years of service; for example, cost-of-living increases for retirees, can create or add to underfunding.

If these increases are permitted to be funded over periods as long as 30 years, plans that grant them, especially those that grant them frequently, can terminate with substantial unfunded benefits.

Generally, insurance coverage is phased in for such increases over 5 years. By contrast, the Corporation's insurance program for multiemployer plans does not insure any benefits attributable to increases until they have been in effect for 5 years.

Factors contributing to plan underfunding at termination:

We reviewed the funding practices for the 33 plans that resulted in 90 percent of the claims against the insurance program during 1983 through 1985. Our review was limited to the 5-year period before plan termination, because earlier data were generally not available.

We found that most of the 23 employers sponsoring the 33 terminated plans were experiencing business hardship during the 5 years before termination. At plan termination, 17 of the employers were in bankruptcy reorganization or liquidation proceedings.

The 33 plans' unfunded benefits increased significantly during the 5-year period. The plans' assets did not cover 44 percent of their vested benefits at the start of the period.

At termination, the plans were 66 percent unfunded. During the 5 years, unfunded benefits almost doubled, to \$450 million.

We identified several factors contributing to the increased underfunding during the 5 years before termination. Although we were not able to quantify the dollar effect of all of the factors, we believe that each contributed significantly to the underfunding of the 33 plans.

Specifically, we found that nine employers received business hardship funding waivers for contributions totaling \$29 million that were unpaid at termination; 12 employers did not make \$41 million in required contributions that had not been waived before termination; 20 employers had \$57 million in current contributions that became due when they terminated their plans; 18 employers increased 27 plans' benefits which were generally guaranteed by the insurance program and unfunded at termination; and most contributions made to the plans before termination did not exceed the minimum required levels.

The 1986 amendments were primarily designed to strengthen the insurance program's financial viability by increasing program revenues and helping to control claims or increase collections from employers terminating underfunded plans.

However, it is too early to tell whether the amendments will ensure the long-term viability of the insurance program. Our review indicates that about half of the \$500 million in program

claims during the 1983-85 period came from underfunded plans of 17 employers who were in bankruptcy proceedings at plan termination.

Considering this, the Corporation's ability to sufficiently improve its recovery of claims from distressed employers is doubtful, even with the increased employer liability.

Recent large claims now raise serious doubt about the ability of the \$8.50 premium to cover future claims and pay off the program's deficit. An \$8.50 rate will retire the newly estimated deficit of \$1.3 billion within 5 years if future claims average \$100 million a year.

However, the Corporation now forecasts future claims to average between \$220 and \$450 million a year. Based on these forecasts, the Corporation estimates that the program's deficit could grow to between \$1.5 and \$2.5 billion within 5 years without another premium increase.

We believe these forecasts are reasonable, given our past analyses of premium needs and the program's recent claims experience.

Some plans are significantly underfunded. Current law may not be adequate to protect the insurance program from potential large claims should these plans terminate. Therefore, further changes should be considered to protect the program's viability.

Such changes could include modifying current law to require more rapid payment of unfunded benefits, especially those resulting from benefit increases; require employers to make minimum contribution payments to their underfunded plans sooner than 8½ months after the end of the plan year; further limit the guarantee of benefit increases; and raise the premium rate to provide the revenue needed to retire the program's deficit and pay for estimated future claims.

This concludes my testimony. We will be happy to answer any questions at this time. Thank you, Mr. Chairman.

Chairman PICKLE. Thank you, Mr. Delfico.

I am looking at your testimony starting on page 5, where you single out some of the plans that you have examined, the 33 underfunded plans. You make the statement that those plans at termination were 66 percent unfunded.

You tell what had happened to those plans. You continue on the next page, and say nine employers received business hardship funding waivers for contributions totaling \$29 million. Who gave them those waivers?

Mr. DELFICO. IRS had granted those waivers.

Chairman PICKLE. The Internal Revenue Service gave the waivers?

Mr. DELFICO. Yes, sir.

Chairman PICKLE. Do they have guidelines, a formula they follow, or some sort of an in-house system they have established?

Mr. DELFICO. They have got general guidelines and formulas that they do follow for granting waivers. Some they grant and some they don't. There are a considerable number that they do not grant.

Chairman PICKLE. Another 12 employers did not make \$41 million in required contributions that had not been waived. So even

though they hadn't gotten the waiver, they just didn't make the contribution.

Mr. DELFICO. Yes.

Chairman PICKLE. Does the PBGC hold them accountable? You see that they don't make their contributions. You know that. What do you do about it?

Mr. DELFICO. We brought it to the IRS's attention 3 weeks ago, and they are looking into that now. We will soon find an answer to that question.

Chairman PICKLE. You say IRS is looking at it. What are you doing about it?

Mr. DELFICO. We are following up on our questions to find out what actions they have taken and what they are considering to do in that area.

Chairman PICKLE. In a case where an employer does not make a contribution, and it has not been waived?

Mr. DELFICO. Yes, sir.

Chairman PICKLE. At this point, nobody lays a glove on them, neither IRS nor the PBGC?

Mr. DELFICO. Mr. Reynolds may have something more specific.

Mr. REYNOLDS. Once the plan terminates, PBGC has to go after them to try to recover the money.

Chairman PICKLE. Well, does PBGC go out and do it?

Mr. REYNOLDS. After the plan terminates, yes, they try and recover it.

Chairman PICKLE. You say 20 employers had \$57 million in current contributions that became due when they terminated their plans. What happened to that money?

Mr. REYNOLDS. PBGC tries to recover from the employer those amounts, after the plan terminates.

Chairman PICKLE. Well, it seems to me like you are finding a situation where you can see that the company is in trouble—you found that in this 5-year period—you can almost spot it and yet, there is nothing on the books to try to tighten it up.

Why are these plans underfunded? Is it just business conditions, or do they just take it all for granted, or are they always willing to give higher benefits?

Mr. DELFICO. Business conditions, as you pointed out. In a number of cases, the plans that we looked at were very underfunded. The employers were for the most part, not healthy during this time period, and that contributed quite a bit to the problem.

Chairman PICKLE. I notice your recommendations here, and I am going to come back to some of these things. You made at least four specific recommendations, or things that could be considered, and we are glad to have those.

What did you find? Are you finding that a great number of these plans are underfunded, and if changes are not made, it is your estimate that the deficit of the PBGC will probably go to at least \$2.5 billion in the next 5 years, up from \$1.5 billion now?

Mr. DELFICO. That is correct.

Chairman PICKLE. So, obviously, some changes must be made in these single-employer underfunded plans.

Mr. Schulze?

Mr. SCHULZE. Thank you, Mr. Chairman.

I would like to go into a little more detail on the requirements which the IRS has formulated for one, applying for a waiver, and two, granting the waiver. Can you also tell us if any of the 23 employers you referred to had one, applied for a waiver, and two, why it was not granted? Based upon the figures you cited, employers that apply for funding waivers are having business problems and are seeking assistance. Should the statute be changed to allow more relief to those applying for a waiver?

Mr. DELFICO. Mr. Reynolds did that analysis for us.

Mr. REYNOLDS. The first step—

Mr. SCHULZE. Speak right into that microphone.

Mr. REYNOLDS. The first test is that a business hardship exists, so any employer who has not made the minimum contribution to a plan, if they are experiencing a business hardship, may request a waiver from IRS.

Mr. SCHULZE. How many do? Is this a very little-used section, or do we get a lot of requests for waivers?

Mr. REYNOLDS. IRS hasn't kept statistics for the last 3 or 4 years, but in 1980 to 1983, there were around 1,000 requested for waivers. Once the request is made, IRS must then look and see if there is a likelihood that the plan will continue if the request is granted, and they may enter into an agreement to pay back the money over a 15-year period.

Mr. SCHULZE. Any criteria they use in making that determination?

Mr. REYNOLDS. It is a case-by-case basis. They request a lot of financial information from the employer, the reason for the hardship also, they collect information so they can determine the likelihood that the hardship will go away and that the plan will be able to continue.

Mr. SCHULZE. Do they have specialists who are engaged in this, or a regular agent who would be handling this type of work?

Mr. REYNOLDS. They have a unit that routinely handles these requests. There are 10 people in the unit, but they don't work on the waivers 100 percent of the time. They estimated to us that they spend 3 to 4 staff years.

Mr. SCHULZE. I presume the unit is headquartered in Washington?

Mr. REYNOLDS. Yes.

Mr. SCHULZE. When a waiver request is filed, does an agent then go out on the site and look at this operation?

Mr. REYNOLDS. I believe primarily it is handled here in Washington and information is provided to the headquarters unit to make the decision.

Mr. SCHULZE. In other words, they write to the waiver requester, and ask him for certain materials, and they take them at face value?

Mr. REYNOLDS. I think there are a lot of questions and give-and-take before the final decision is made.

Mr. SCHULZE. Are you satisfied that the IRS fulfills its role as a watchdog in granting these waivers, and does its work adequately, and carefully?

Mr. REYNOLDS. We didn't analyze how they review the waivers. We didn't look at the kinds of decisions that they were faced with.

Mr. SCHULZE. Unless I am mistaken, this is a fairly important part of this operation, do you agree with that?

Mr. REYNOLDS. Yes.

Mr. SCHULZE. It is key. If you are looking into this in your usual thorough way, you might have a good idea whether they are doing it right or not. If you think there is more that needs to be done, you better let us know.

Mr. DELFICO. Fine, we have been working with the IRS, and that is one of our objectives, to find out what is it they are finding.

Mr. SCHULZE. If you will also speak up a little bit more.

Mr. DELFICO. We have been working with the IRS throughout this study. They have been helpful in granting us information we need. We will get back to you.

Mr. SCHULZE. You have not concluded that portion of your investigation, and you are looking into that relationship.

Now, out of the 1,000 applicants, how many waivers were granted, do we have figures on that?

Mr. REYNOLDS. I believe there were around 800, in the 1980-83 time period. There are an awful lot that are administratively closed. It is misleading to look at how many were approved and denied.

There are an awful lot where the employer requests the waiver, and after he sees that he must provide information to prove a business hardship, he just withdraws the request.

Mr. SCHULZE. Do you have any recommendations in that area? Is that something which perhaps needs change?

Mr. DELFICO. We are looking into that aspect of it. We have completed about three-quarters of our investigation at this time, and the waiver situation is one issue we are looking at.

Mr. SCHULZE. Are employers increasing benefits at the same time they have an inadequately funded a program or plan?

Mr. DELFICO. In some cases, we found, yes, they were. They would increase benefits that would become effective in years after they asked for a waiver.

Mr. SCHULZE. In your opinion, is this done when a company is in big trouble and as a consequence is trying to give their employees something to attract and keep them? Is it promising something it has a feeling it really can't deliver?

Mr. DELFICO. We have noticed in our sample data, most of the companies had plans that were negotiated plans and that could be one reason for the problems.

Chairman PICKLE. Would you yield? I want to follow through on a comment of your's.

In some of the instances where the employers had increased their plans benefits, are you saying that sometimes a waiver was asked for at the same time benefits were being increased?

Mr. DELFICO. Yes, benefits increased sometimes after the waiver had been granted.

Chairman PICKLE. The employer would ask for a waiver on the funding and at the same time he was increasing the benefits?

Mr. DELFICO. Because the benefits were put in as a plan amendment prior to the requests for a waiver, the benefits would become in effect 3, 4 years after the waiver was granted.

Chairman PICKLE. Concerning the number of companies that have asked for these waivers and been granted waivers, what percentage were successful later?

Did they go under eventually? Is there a criteria or measurement of their viability?

Mr. DELFICO. We are looking into that specific question. We don't have the statistics on that right now, Mr. Chairman.

There are some companies, clearly a lot of companies that may get through the waiver process, and they become healthy again. The waivers do help.

Chairman PICKLE. What you indicate is that a company might ask for a waiver, and at the same time increase benefits. Normally that company doesn't make it.

Mr. DELFICO. From our sample that is true. The companies we looked at would normally go through a 5-year cycle, increasing benefits and then terminating plans.

Mr. SCHULZE. Page 7 you state one-half of the \$500 million came from underfunded plans of 17 employers who were in bankruptcy proceedings at plan termination.

Did any or all of these 17 employers ask for waivers?

Mr. DELFICO. I think they all had asked for waivers.

Mr. REYNOLDS. Most of them.

Mr. SCHULZE. Do you have any recommendations on early action? It seems to me that there are early indications of problems, and perhaps we should take some action or allow action to be taken at this time.

What kind of recommendations do you have along those lines?

Mr. DELFICO. Well, one recommendation we have for your consideration is to reduce the 8½-month period allowed for plan contributions after a plan year ends.

Mr. SCHULZE. That would be across the board or just for those who are in trouble?

Mr. DELFICO. Just for those in trouble.

Mr. SCHULZE. If you requested a waiver—then you are going to discourage people from requesting a waiver—when you say as soon as you request a waiver you have to pay up everything automatically.

Mr. DELFICO. It is a delicate balance. There are very healthy plans out there. Across-the-board recommendations would have to be thoroughly considered.

We would prefer to develop recommendations that would be focused on those unhealthy plans.

Mr. SCHULZE. You anticipate completing your study when?

Mr. DELFICO. Roughly, in 3 months.

Mr. SCHULZE. OK. Well, I will hold off until it is completed.

Thank you, Mr. Chairman.

Chairman PICKLE. Mr. Crane, do you have any questions?

Mr. CRANE. No questions.

Chairman PICKLE. Mr. Daub?

Mr. DAUB. No, Mr. Chairman, except to commend you for these hearings.

I spent the better part of my private life in the legal work of advising and managing 54 retirement plans. I do think we should not overreact.

There were a number of reasons why the 118,000 plans exist and why 68,000 or 70,000 of them terminated. We ought to await the conclusion of your report before we decide that the underfunding problem is sufficiently severe that we penalize a system, the large majority of which is being properly managed.

Chairman PICKLE. Thank you, Mr. Daub.

In one of your recommendations you said you should further limit the benefit increases. How do you do that? Explain that further.

Mr. DELFICO. On one extreme, you could consider the model that the multiemployer plans use.

Chairman PICKLE. I have to ask you to speak into that microphone.

Mr. DELFICO. On one hand we could use the model of the multiemployer plans. They don't guarantee benefit increases made within 5 years before plan termination.

You can go from there to not guaranteeing any benefit increases made within a shorter time period before termination.

We would not want to restrict any benefit increases during a specific time period, but you may want to consider not guaranteeing benefit increases because they do contribute to plan underfunding and there are a sizable number of them.

Mr. SCHULZE. Would the chairman yield?

Chairman PICKLE. I yield.

Mr. SCHULZE. Is there a norm beyond which deviation becomes obvious, and around which we could draw certain parameters?

Mr. DELFICO. There are norms you can develop, but we have not done that work in our study. But I would suspect—there are indicators of hardship, pending failure or termination.

Chairman PICKLE. How would you limit the guarantee of benefit increases? Would retirees be limited in the amount of money that they could receive?

Mr. DELFICO. If you don't guarantee benefit increases, yes, that would be a consideration.

Chairman PICKLE. Who would make that decision, PBGC?

Mr. DELFICO. I would suspect yes, they would make a decision whether or not to do that.

Chairman PICKLE. You recommended that you increase premiums?

Mr. DELFICO. Yes.

Chairman PICKLE. How much increase could you have? We have gone from \$1 to \$8.50. There is considerable criticism now by those pension plans that are well funded, doing well. They argue that all you are doing is socking it to them so that the others that eventually go under are protected. You have to raise a question. How much can you raise it? How much premium increase do you think the program could stand?

Mr. DELFICO. That is a tough question. To amortize the current estimated deficit, it would probably take about \$13.50. We agree with PBGC's estimate of the deficit.

Chairman PICKLE. You are saying under normal circumstances and with the current program now you could increase the premium up to \$13 or \$13.50?

If we did that, would that cause some of the smaller companies to go out of business?

Mr. DELFICO. It could very well do that. However, we don't know the economic impact of that \$5 premium increase.

Chairman PICKLE. Do underfunded plans have any common characteristics? Aren't there some common characteristics among these plans that are going under?

Mr. DELFICO. They vary by industry. In the 1983-85 time period, the steel industries are prominent in our sample. Most of the plans we looked at were in bankruptcy or going into bankruptcy.

Chairman PICKLE. Is there a common average age?

Mr. DELFICO. I think these plans are between 10 and 20 years old, somewhere in that range.

Mr. REYNOLDS. Between 20 and 25 years that they had operated before termination.

Chairman PICKLE. Has the ERISA Program in general aided those companies, helped them or hurt them?

Mr. DELFICO. That is a hard question to answer. By and large, the ERISA has helped the participants in these plans. One hundred and sixty thousand people are receiving benefits now that wouldn't have if we didn't have ERISA.

Chairman PICKLE. Would you say that any of these claims represented employers who were dumping their pension plans, getting rid of it for financial reasons or insurance reasons?

Mr. DELFICO. Others have said that, and there are indications that that might be the case.

Chairman PICKLE. Have you identified those?

Mr. DELFICO. No, sir.

Chairman PICKLE. How many of the employers who filed for bankruptcy actually did go out of business?

Mr. REYNOLDS. Of the 23, 3 were in chapter 7 bankruptcy, so they were liquidating. The rest are still in some process of chapter 11, trying to develop a plan of reorganization.

Chairman PICKLE. Well, I want to say—

Mr. DAUB. Mr. Chairman, on that last one, do you see any developing trends in your agencies on the essential health of the economy curve?

If you were looking at the 1980, 1981, 1982 cycle or the 1982, 1983, 1984 cycle, as the economy shifted to a more stable rate, the interest, inflation rate down, portfolios up, is this changing? In other words, the health of your economy ameliorates some of the dangers that are there?

Do you see the less well-managed funds responding better if the economy is generally healthier?

Mr. DELFICO. By and large, there are two sides to that. As interest rates go down, computations of plan liabilities go up, and consequently deficits go up.

On the other hand, assets will rise, but if you are underfunded, you are in a bind. Your assets don't go up as quickly as your liabilities do.

Mr. DAUB. If you increase the premium by \$5, those marginal but balanced plans will say, hey, the overhead is too much, we are going to quit. Do you agree with this?

Mr. DELFICO. There is that danger, Mr. Daub.

Mr. DAUB. Thank you, Mr. Chairman.

Chairman PICKLE. We appreciate the GAO's examination of these underfunded plans, which was conducted for the subcommittees at our request.

I know Mr. Jones and I appreciate it. We may well want this to be an ongoing investigation.

It seems to me that there is no question that we have a severe problem with these underfunded plans. The deficit is now \$1.3 billion or thereabouts, and even with premium increases and an increase of \$8.50, the deficit will grow to \$2.5 billion in the next 5 years. It is obvious that we will not have cured some of the basic problems with underfunded plans.

We would have to expect greater action from both the IRS, the PBGC, and the Congress. Together we will try to improve the program. We will be asking you to look into this further. We got a good background now.

Now the Chair will ask the next panel to come forward. We have a representative of the IRS, Robert I. Brauer, Assistant Commissioner, Employee Plans and Exempt Organizations. Also, we have before us Dr. Kathleen Utgoff, Director of the PBGC, the Pension Benefit Guaranty Corporation.

Mr. Brauer, identify the individuals with you at the witness table.

Mr. BRAUER. I have with me on my immediate right, William Posner, Special Assistant for Employee Plans Matters, and to his right, Kenneth Yednock, Chief of our Projects Branch, who is an actuary.

Would you like me at this time to read my statement, Mr. Chairman.

Chairman PICKLE. You may proceed.

**STATEMENT OF ROBERT I. BRAUER, ASSISTANT COMMISSIONER,
EMPLOYEE PLANS AND EXEMPT ORGANIZATIONS, INTERNAL
REVENUE SERVICE, ACCOMPANIED BY WILLIAM POSNER, SPE-
CIAL ASSISTANT FOR EMPLOYEE PLANS MATTERS; AND KEN-
NETH YEDNOCK, CHIEF, PROJECTS BRANCH, EMPLOYEE
PLANS TECHNICAL AND ACTUARIAL DIVISION**

Mr. BRAUER. We are pleased to be here in order to discuss the minimum funding standards set forth in the Internal Revenue Code and the underfunding of employee pension plans, as well as the role of the Service in enforcing these standards and in granting waivers.

In my remarks today I will first discuss the minimum funding standards and the policy behind them, including the balance ERISA struck between rapid funding and the desire to encourage significant benefits for older workers. I will then discuss the importance of funding waivers to the overall structure.

BACKGROUND

The funding standards of the code, as enacted in the Employee Retirement Income Security Act [ERISA] and administered by the Service, require an employer to make a minimum contribution for each year to a pension plan based on the funding method used for

the plan. Generally, there are two parts to this contribution. The first part is normal cost. Normal cost refers to the annual cost of future pension benefits assigned to future years. The second part of the contribution is the amortized portion of the past service cost. The amortized portion of the past service cost refers to the annual cost of pension benefits attributable to past service amortized over future years. Amortization of past service cost works similar to amortization of a mortgage. Thus, amortizing past service costs over 30 years is analogous to paying off a mortgage over 30 years.

MINIMUM FUNDING STANDARDS

If the contributions to a pension plan are sufficient to cover both the normal cost and the amortized portion of the past service cost, the plan meets what we refer to as the minimum funding standards. Violation of the minimum funding standards subjects the employer to excise taxes imposed by the code, but does not result in loss of a plan's qualified status.

The Service reviews the plan's funding as part of its examination program and not as part of the determination letter process. Our determination letter process is concerned with whether a plan meets the qualification requirements of the code. Since funding has no effect on qualification, we do not consider funding in determining whether a plan is qualified.

At first glance, the factors used in determining the contributions required to meet the minimum funding standards would appear to be objective in nature. The code calls for precise charges and credits with specific amortization periods for several of these charges. In fact, however, determination of the contributions required to meet the minimum funding standards is quite subjective. The reasons for this are as follows.

Actuarial assumptions are used to estimate the annual contributions that will be necessary to accumulate sufficient assets to pay benefits under the plan. Actuarial assumptions include estimates of future mortality, interest, turnover, salary increases, early retirements, et cetera. ERISA requires only that these assumptions be reasonable in the aggregate.

A change in an actuarial assumption can have a substantial effect on the plan's cost. For example, plan costs may vary significantly depending on the interest rate used. An actuarial rule of thumb is that the costs decrease approximately 6 percent for each increase of one-fourth of 1 percent in the interest assumption. Thus, under the rule of thumb, an assumed interest rate of 7 percent rather than 6 percent would decrease costs by 24 percent.

Another factor significantly affecting the contribution required to fund a plan is the choice of funding method. A funding method is a way of determining how the contributions needed to pay the plan's benefits will be spread over a period of years. Under some funding methods, the cost for a particular year may be more than twice as great as the cost under other funding methods, using the same actuarial assumptions. ERISA describes six acceptable funding methods and permits others that the Service finds acceptable.

So it is fair to say that there is considerable flexibility in the choice of funding methods and actuarial assumptions. These

choices will have a significant impact on the determination of the specified amount needed for any plan year to satisfy the minimum funding standards.

UNDERFUNDED PLANS

This hearing is specifically concerned with underfunded plans. This is a term that has no universally accepted meaning even among actuaries. For purposes of this testimony, however, we will assume that an underfunded plan means a plan that would not have sufficient assets to pay liabilities if the plan terminated at this point in time.

A plan that satisfied the minimum funding standard may nonetheless be underfunded. For example, consider a new plan under which most of the benefits are to be paid to persons who are retired or eligible to retire. A large past service liability arises. The contribution to provide those retirement benefits can be amortized over 30 years as we discussed earlier. Suppose, however, that the plan's terms require that all benefits are to be paid out to the retirees over the remaining period of their lives, and their average life expectancy is only 15 years. In such a case, benefits that are currently payable under the new plan may well exceed the contributions required to fund the plan under the minimum funding standards. Not only is it likely that the plan will be underfunded in the plan's early years, it will, in fact, be underfunded for many years to come; yet it could always satisfy the minimum funding standards. This example demonstrates that the minimum funding standards do not necessarily prevent underfunding.

While eliminating underfunding is an important goal, there are other competing goals to be considered. Let's take the example of a company with a significant number of employees of all ages. The company wants to establish a plan providing past service benefits so as to reward, among others, long-term employees. As employees become older, the cost of providing benefits to those employees increases. The increase becomes very dramatic as the employees approach retirement.

If the code required the employer to immediately fund the past service benefits for those long-term employees, the cost would be prohibitive. Such a requirement would, therefore, effectively operate to eliminate past service benefits from most plans.

In order to avoid making the costs of providing benefits on account of past service prohibitively expensive, ERISA permits employers to fund such benefits over a period of years, which may exceed the period over which benefits may be paid out. Thus, the minimum funding standards consciously permit underfunding as a matter of policy.

From our experience, we would suggest that underfunding most often occurs in two situations in addition to those plans that provide large past service credits. I would caution that these are generalities, and any specific plan might not fit the mold.

First, when the employer is in a declining industry, plans are frequently funded at the lowest level permitted by law. This is not surprising. As might be expected, the level of pension funding—at

least to the extent of funding above minimums—varies with the health of the company making the contribution.

Second, underfunding frequently occurs in plans where benefit levels are unrelated to pay, such as \$10 per month per year of service for each employee regardless of compensation level. In these cases, each time benefits are increased, the plan's liabilities on account of prior service also increase. These liabilities can be amortized over 30 years.

WAIVERS

Let me now discuss the related matter of waivers. ERISA recognized that some employers might not be able to satisfy the minimum funding standards in a given year. To deal with this, the funding standards provide a waiver process for employers facing temporary business hardship. The Service may agree to waive a year's minimum funding requirement upon finding that, one, substantial business hardship exists; two, application of the minimum funding standards would be adverse to the interests of plan participants in the whole; and, three, it is reasonable to expect that the plan will be continued if a waiver is granted. Under the code, waivers can be obtained as many as five times in a 15-year period and any amount waived must be amortized over not more than 15 years.

Waivers are an important part of the funding rules. Absent waivers, companies which temporarily cannot make the minimum contribution required by the funding requirements might have to terminate or modify their plans. In some instances, a waiver will provide enough relief to enable a financially distressed company that would otherwise have terminated its underfunded plan to recover without the need to terminate. In such a case, the waiver would save the Pension Benefit Guaranty Corporation [PBGC] from liability and provide participants with continued pension benefits. The PBGC guarantees the payment of certain pension benefits to employees when plans terminate with insufficient assets.

There is also a negative side to waivers. They decelerate the rate of required funding and in most instances decrease the amount of money that is available to pay benefits. Also, if a plan receives a waiver and subsequently terminates, the PBGC's liability could increase on account of the granting of the waiver.

It is very difficult to objectively evaluate the net effect of the waiver program on participants or the PBGC. Any evaluation would have to consider, among other things, whether the plan would have terminated or whether additional contributions would have been made if the waiver had been denied.

SEPPAA

The recently enacted Single Employer Pension Plan Amendments Act of 1986 [SEPPAA] significantly affects the waiver program. It clarifies the statutory authority of the Service for requiring a security interest when a large waiver is granted, which limits the downside risk to the PBGC insurance program. It also requires repayment of the waived amounts using a market rate of interest

rather than at the generally lower plan funding rate that was used under prior law.

In addition to its impact on waivers, SEPPAA should affect the general funding decisions of employers.

SEPPAA limits the advantage to employers of maintaining underfunded plans by providing that a plan cannot terminate unless benefit commitments are satisfied or the employer is in financial distress. Under this distress criterion, some employers, depending on their financial conditions, may face increased liabilities—over prior law liabilities—to the PBGC and plan participants if they terminate a plan that has inadequate assets. Thus, employers cannot eliminate their obligations for pension promises as cheaply as before.

As a final note, we expect that the new Financial Accounting Standards Board [FASB] rules for pension plan accounting, when effective, will also have an impact on funding. The new rules essentially require employers to reflect the underfunded status of their pension plans on their balance sheets as a liability in certain instances.

While it is still too early to assess the changes in the law and accounting standards, it appears that they will reduce the underfunding of plans.

This concludes my testimony. We would be happy to answer any questions you may have.

Thank you.

STATEMENT OF KATHLEEN UTGOFF, PH.D., DIRECTOR, PENSION BENEFIT GUARANTY CORPORATION, ACCOMPANIED BY TOM VEAL, DIRECTOR, CORPORATE POLICY AND REGULATIONS; ED MACKIEWICZ, GENERAL COUNSEL; AND DAVE GUSTAFSON, MANAGER, ACTUARIAL POLICY DIVISION

[The prepared statement begins at p. 61]

Ms. UTGOFF. On my left is Tom Veal, who is head of our Corporate Policy and Regulations Department, and behind me is our General Counsel, Ed Mackiewicz; and Dave Gustafson of our Actuarial Policy Division.

I would ask that our written statement be included in the record, and that I will read our shorter oral remarks.

Chairman PICKLE. It will be included.

Ms. UTGOFF. Thank you.

Thank you for this opportunity to present the views of the Pension Benefit Guaranty Corporation on the underfunding of private pension plans. Underfunding is a vital concern to the PBGC, because we—that is, the 110,000 pension plans that pay premiums to our insurance program, must absorb most of the cost of inadequately funded pension promises.

The cost also falls on pension plan participants, who frequently suffer benefit cutbacks when an underfunded plan terminates.

The cost of underfunded pension plans has turned out to be much greater than anyone expected when the PBGC was established in 1974. At that time, Congress envisioned a small, inexpensive program that would protect workers in those relatively rare

instances when pension plans terminated without the funds to pay promised benefits.

Before ERISA was passed, a Department of Labor study concluded that a pension insurance program would incur about \$25 million in net claims each year, an amount that could be covered by a PBGC premium of \$1 per insured plan participant.

Experience quickly altered those expectations. Almost from its first day, the PBGC operated at a deficit. Congress raised the premium from \$1 to \$2.60, starting in 1978. This amount also proved inadequate. In 1982, the PBGC was forced to request another premium increase.

We also requested reforms to correct weaknesses in the insurance program. The Single-Employer Pension Plan Amendments Act of 1986, which was signed into law on April 7, included a premium of \$8.50 per participant and more limited reforms than the administration had asked for.

Unfortunately, an \$8.50 premium and the reforms included in the bill will not cure the PBGC's financial woes. At the end of 1985, we estimated that a premium of \$13.50 per participant was needed to cover future claims and retire the PBGC's \$1.3 billion deficit.

The same projections showed that with an \$8.50 premium, our deficit would grow at a rate of \$100 million per year.

Why has the modest program that Congress approved in 1974 become so much larger and more costly than anyone anticipated? The primary reason is that the plans that now come to the PBGC for help are larger than ever before and less well-funded.

The PBGC has been in existence for 11 full years. During the first 4 years of the PBGC's history, the average plan taken over by the PBGC was 55 percent funded for guaranteed benefits.

That ratio dropped to 47 percent during the next 4 years, and to 38 percent for the most recent 3 years. While funding ratios were declining, the average amounts of underfunding increased dramatically, from \$300,000 per plan in the next 4, to \$1 million in the next 4, to \$3.5 million in the last 3.

At first glance, this trend is a surprise, for pension plans in general have become better funded over the years. The percentage of terminating plans that are fully funded has roughly doubled over the past 3 years.

It was estimated that near the end of 1985, defined benefit pension plans as a whole were overfunded by 40 to 50 percent. Clearly, the rules that govern pension funding have led to increased disparities between well-funded and poorly funded plans.

The incentives that give rise to this disparity stem from the structure of the PBGC insurance program. In addition, the minimum funding standards are not designed to ensure that plans become fully funded. Waivers of minimum funding compound the program. I should like to address each of these points in turn.

Under current law, the PBGC must charge the same premium per participant to all covered plans, regardless of the size of a plan's unfunded liabilities or risk that it poses to the insurance program.

Furthermore, although the PBGC can, in theory, recover some of its losses from plan sponsors, most of our claims have only unse-

cured creditor status in bankruptcy. Consequently, our claims are worth only about 7 to 15 cents on the dollar.

Because the premiums are not risk-related and the PBGC has such weak standing in bankruptcy, companies that are experiencing business difficulties have little incentive to fund their pension plans.

An obvious strategy for both employers and employees is to cut back funding and use the savings for other purposes. The PBGC picks up the tab if the plan terminates. Under present law, this is both rational and legal.

The termination of Wheeling-Pittsburgh's pension plans showed just how profitable underfunding can be. By terminating its plans, Wheeling-Pitt saved over \$3 per hour in pension costs, a subsidy that will be paid for by companies that offer defined benefit pension plans.

Wheeling-Pitt's competitors in the steel industry will bear a double burden: They will have to compete with a company that has been granted a significant labor cost advantage and they will also have to bear the cost of higher PBGC premiums.

Of course, other steel companies with underfunded plans can follow in Wheeling-Pittsburgh's footsteps, if they meet the requirements of the new law, but it seems reasonable to ask whether these crisscrossing subsidies do the steel industry or the economy any good. Certainly, they do not lead to a sound pension insurance program.

The current structure of the PBGC's program encourages troubled companies to underfund their pension plans. At the same time, such tactics are abetted by some of the legal rules that govern plan funding.

Both ERISA's minimum funding standards and the provisions for waiving the minimum funding requirements contribute to the problem.

A plan can meet statutory minimum funding standards and nevertheless remain woefully underfunded. When this happens, the PBGC can suffer huge losses. Our second largest insurance loss came from Allis-Chalmers. Its plan had met or exceeded minimum funding requirements every year since the enactment of ERISA.

The plan had assets that were \$170 million short of guaranteed benefits when it terminated. The plan's assets covered only 3 percent of the liabilities.

One way to avoid these large losses is to reformulate the minimum funding standards in order to place greater emphasis on underfunding. The current standards are designed to spread costs over future generations of workers and stockholders, not to insure that plans will be fully funded at any particular point.

In situations such as the one that I just described, funding standards based on cost-spreading can lead to a rapid deterioration of funding that may eventually fall on the shoulders of the PBGC's premium payers.

In the PBGC's view, the minimum funding standards need to be reexamined with the goal of preventing grossly inadequate funding, without imposing extra costs on sponsors of well-funded plans. I am submitting some possible approaches in my statement for the record.

Even when the minimum funding standards are adequate, they can be waived for companies in distress. Many of the largest claims against the PBGC have come from plans that received funding waivers during the last few years before termination.

Wheeling-Pittsburgh, for example, was granted funding waivers for 1982 and 1983. They also made no contributions for 1984 and 1985.

The PBGC reform package that was proposed by the administration required security for all funding waivers above a small amount unless the Internal Revenue Service and the PBGC agreed to an exception.

A minimum funding waiver is the same as a loan from a plan to the plan sponsor. If the plan is underfunded and on the brink of termination, the real lenders are the PBGC premium payers.

The administration believed that since it was the PBGC premium payers' money that was on the line, we should have some say in setting the terms on which we extended credit. We would not, of course, have been precluded from making the sort of rational accommodations that any lender must consider.

Each case has to be evaluated on its merits, a task that is best performed by those who have a financial stake in the outcome.

SEPPAA's provisions relating to minimum funding waivers did not include the security protections that the administration had requested. On the plus side, the IRS has made every effort to keep the PBGC informed of significant minimum funding waiver requests, and in two recent cases, they have arranged for adequate security for funding waivers. These developments are very encouraging.

In summary, I should like to emphasize the following points:

First, despite the general improvement in pension plan funding since 1974, the funding of those plans that take advantage of the PBGC has deteriorated, placing greater pressure on an already overburdened insurance program.

Second, the structure of the PBGC insurance program, with identical rates for good and bad risks and with low priority for its claims in bankruptcy, encourages the riskiest companies to underfund their plans.

Third, minimum funding waivers should not be used as a source of corporate financing that undermines pension security.

Fourth, the minimum funding standards do not protect the PBGC or plan participants in a number of cases. In the PBGC's view, the funding standards need to be reexamined.

I will be happy to answer any questions that you may have.

Chairman PICKLE. Thank you very much.

I notice, Dr. Utgoff, that you make some specific recommendations. First, on page 4, you make some observations about the minimum funding standards. At the conclusion you recommend about four different things that could be done.

Have these recommendations been conveyed to the Congress?

Ms. UTGOFF. Many of them were part of the deliberations over the enactment of the last law. We have also communicated to the Congress on a number of occasions the problems with PBGC—the bleak financial picture that we are now facing.

Chairman PICKLE. I am trying to follow you but you haven't said it together. I am asking you the question: Have you made these recommendations to Congress?

Ms. UTGOFF. We made the recommendations about the minimum funding waiver specifically to the Congress.

Chairman PICKLE. To whom did you make those recommendations?

Ms. UTGOFF. They were part of the administration proposals that were submitted in the reform package for the single employer insurance program. They were not adopted by Congress.

Chairman PICKLE. Are you saying that the administration's proposal regarding the bill we recently passed included these recommendations, but they were not made part of the bill that was enacted?

Ms. UTGOFF. That is right. The administration's minimum funding waiver provisions were not included in the final bill.

Chairman PICKLE. Well, I find that interesting. We will look into it further. This subcommittee, of course, is concerned with the funding aspects, of the single-employer pension plans and the taxes that would be involved. We are not the authorizing committee, but if your recommendations were part of the overall package and they were part of the SEPPAA bill, and part of it wasn't adopted, at least you made the recommendations. Have you ever made any similar recommendations or passed such information on to this committee?

Ms. UTGOFF. This committee held hearings on the SEPPAA bill and then there were deliberations which led to the compromise that became the final SEPPAA bill.

Chairman PICKLE. This committee, I repeat, is concerned with the funding aspect of PBGC and the taxes involved. However, we have concurrent jurisdiction on pension plan issues. We also notice recommendations being passed on to Congress, or to the Education and Labor Committee, in determining the level we need to set for the taxes.

Now, Mr. Brauer, have you made any recommendations to the Congress?

Mr. BRAUER. We have not made recommendations as such, Mr. Chairman.

Chairman PICKLE. What I am trying to find out is, PBGC views with alarm these underfunding liabilities plans.

Ms. UTGOFF. Yes.

Chairman PICKLE. Your recommendation to this subcommittee, so far, has primarily been to raise premiums. We have had other recommendations, they have—

Ms. UTGOFF. I have talked before this committee about the need to increase our recoveries in bankruptcies, the need to protect us from the kind of abusive transfers that we have seen and about the financial picture, what the causes of those problems are.

Chairman PICKLE. I want to ask you, Mr. Brauer, some questions. I am trying to find some way to find an answer, maybe it is the activities of the underfunded plan firms, maybe it is the funding standards, maybe it is the premium level. We are trying to find some answers to the problems.

I would say to you that most of the people, members of this committee, think that all the PBGC does is come up here to ask that the premiums be increased. That is all we hear or see from you. Now, that was a rather bold statement and it is one member's opinion, but it is shared by a lot of the members. All we know is you say you need more money every time. Now you have gone from \$1 to \$8.50, to \$13.50, just to take care of the deficit we have got now.

Ms. UTGOFF. We have testified three times in the last 3 years about the PBGC's problems.

Chairman PICKLE. You testified you wanted additional premiums. I don't know that the record shows you were that concerned about why you came to need the increase and what should be done to resolve the problem. Of course, this committee is concerned about the funding of it. I just don't believe—I am speaking now as an individual—I do not believe that PBGC has ever strongly conveyed to this committee changes you felt were absolutely necessary, other than to just raise the premiums.

Ms. UTGOFF. I thought that I had made that case fairly strongly. Perhaps I had not.

Chairman PICKLE. We are speaking now as individuals. I think I am speaking for a lot of the members though.

So let me ask you both some of these questions that either one of you might answer. Could you modify the premium funding standards? One way could be to require that retroactive benefit increases be funded faster. What is your answer to that question, either of you?

Mr. BRAUER. I think this is a possibility. I know that the law was changed about 5 years ago reducing the amortization period from 40 years to 30 years, and certainly one thing that the Congress might want to do is consider the possibility of further reducing that period.

Chairman PICKLE. All right.

Dr. Utgoff, do you agree with that?

Ms. UTGOFF. I agree.

Chairman PICKLE. All right. The second possibility would be increasing the time delay before benefit increases become benefits guaranteed by the PBGC. My question is, Should we consider increasing the time delay before the benefit increases become guaranteed?

Ms. UTGOFF. In general, I think that that would jeopardize pension security. What I would prefer would be to make rules so that employers don't in general make pension promises that they have no intention of keeping. So if we had better rules governing the system, then we wouldn't have to worry about these midnight increases, because the pension plan wouldn't in effect be a cookie jar for corporate financing. So I would prefer to keep pension security intact, yet charge more employers more for the promises that they make.

Chairman PICKLE. All right.

Mr. Brauer, do you agree with that?

Mr. BRAUER. I have no comment at all on that. That is largely within PBGC's jurisdiction.

Chairman PICKLE. All right now, next should we restrict the IRS' ability to grant waivers to the minimum funding standards in effect under current law? I am asking you a question, whether we should. That puts you in a little difficult position, but—

Mr. BRAUER. My impression is the waiver program is a valuable one and that to the best of my knowledge, it has up until this point in time, worked largely as the Congress intended it to work.

Chairman PICKLE. As I remember Dr. Utgoff's statement, you had questions about waivers.

Ms. UTGOFF. I do.

Chairman PICKLE. When you say I do, expand on that. Do you mean you do not think we ought to grant waivers?

Ms. UTGOFF. I do not think we should grant waivers that clearly jeopardize pension security. What we have is now a program where when a company gets into trouble, its first line of financing is its pension plan. We are not saying that companies should not be able to make adjustments to help them get out of trouble. I would think that we would make a program where their first resort would not be their pension plan, that all sources of corporate financing, whether it is cutting costs or going to a bank, or getting a pension funding waiver, would receive equal treatment.

The program as we have it now, makes it much easier to get financing from your pension plan through a funding waiver, not putting money into the plan, and it is also true that a troubled company can get that and everything else that the market will bear in addition. So when we go to make recoveries, we see that the companies have all the financing that is supportable in terms of their assets, and in addition, loans from their pension fund, so that the pie is always too small to divide up among the debt; and pension debt is a debt. So that we can never recover from a company for that kind of unsecured waiver.

If, on the other hand, we have had security for the waiver and the waiver were given at reasonable rates, neither of those problems would occur. There would not be overextensions of credit; the firm would not necessarily go to its pension plan first when it got into trouble.

ERISA was meant to make pension plans more secure. In that sense, it has made them less secure because they are now being attacked as a line of first resort when a company gets into trouble.

Chairman PICKLE. I take it you are saying that waivers may be appropriate but there certainly ought to be rules and regulations pertaining to them that ought to be tightened up and made more restrictive?

Ms. UTGOFF. That is right.

Chairman PICKLE. I have a question here for IRS which Chairman Jones of the Subcommittee on Social Security would like asked. Let me just present the question to you. He points out first if an employer fails to make planned contributions that are due, an excise tax is imposed on late contributions. When a company applies for a hardship waiver of the minimum funding contributions is the excise tax penalty waived?

Mr. BRAUER. Let me ask Mr. Yednock to address that question.

Mr. YEDNOCK. Indirectly that is the result. If a company applies for a funding waiver and the service sees fit that the standards in

the code are met to grant that funding waiver, in essence the company will receive a credit in the funding standard account for that plan. A credit this year means that the contribution requirement is waived for this year. Therefore, there might not be a funding deficiency. In most cases there would not be funding deficiencies, there would be no tax to be assessed.

Chairman PICKLE. The next question the committee would ask you is: If the waiver is not granted, are applications for the waiver of minimum funding contributions handled expeditiously by the IRS?

Mr. YEDNOCK. All applications that are filed with the service are handled as expeditiously as we can. Now, there are times when a waiver might be applied for shortly before the last day on which an employer could make a contribution, in order to meet the funding standards. In a case such as that, where we already have a large inventory of waivers, some of which also are in the same category of requesting expedited treatment, we may not be able to act in time before the deadline occurs.

But to the extent that employers who ask for expedited treatment, request these waivers sufficiently in advance of the deadline for making the payments, we can usually meet that time period so that the employer will know our answer before the deadline.

Chairman PICKLE. What is the average time for processing a waiver application?

Mr. YEDNOCK. I don't have anything with me in the way of statistics as to the average time, but averages would be, I think, quite unreliable as to timeframes, because at the time that a waiver is requested, in some instances, all the information required is not there. In other instances, everything might be there, and it may be a very clear cut case that a waiver is clearly in order. In others, it might be difficult to analyze all of the information.

There are times when we have to go to other people, such as evaluation people in the Service, to get more information on a particular, industry.

Chairman PICKLE. My question was what will be an average time that you would use in granting a waiver. One month, three months?

Mr. YEDNOCK. I don't have any statistics on that.

Mr. BRAUER. We will be happy to go back and see if we can determine an average time. My impression would be, Mr. Chairman, that the average time would be in the range of 2 to 3 months.

Chairman PICKLE. This is an observation from the Social Security Subcommittee chairman. He has heard of cases where the application for a hardship waiver has taken more than a year to process. All the time the excise tax penalty is accumulating. The excise tax penalty grows, then becomes so large it exceeds the amount of minimum funding contribution that was trying to be waived. So if you wait for over 1 year, the whole purpose of it is defeated.

I find it odd you couldn't tell me when a waiver is granted. A year, a short time, or over a year?

Mr. BRAUER. Why don't we supply that information for the record? I will say there are very few, if any, requests pending with us for more than a year.

[The following was subsequently received:]

The average time for cases closed in 1986 is 7 months.

Chairman PICKLE. Well, I am glad to hear that, but you see, that would be a problem, wouldn't it?

Let me ask you all another question. Should we restrict the actuarial formula by which plans estimate their future assets and liabilities? Currently there are a variety of methods that actuaries are permitted to use and each method results in a different funding requirement. My question is, Should we mandate a specific actuarial formula by which the plans estimate future assets and liabilities?

Mr. BRAUER. Mr. Yednock.

Mr. YEDNOCK. When ERISA was enacted, that was considered—it was a considered judgment at that time that with respect to the actual funding and what constitutes sound funding, there is no one specific definition of what funding would make a plan actuarially sound. Some plans, simply because of the nature of the employer or the nature of employment covered, can be properly and soundly funded with a much lower level of plan assets than other types of plans or plans of other employers in different situations.

It was decided that to try to restrict the flexibility of employers in funding, for example, require a specified level of funding where the plan liabilities are not known at inception and where they are dependent upon the future experience—would be a restriction that could result in some employers deciding not to establish defined benefit plans. It was considered that there was a sound policy to enable employers to adopt one of the six specifically permitted methods and other methods that could be acceptable in given situations and put a responsibility on the actuary for choosing the funding method and the actuarial assumptions in the interest of the plans participants.

Chairman PICKLE. Well, I think I will ask for general comments. GAO testified that the PBGC has a deficit now of \$1.5 billion and it is going to go to \$2.5 billion very soon. Do you disagree with the estimate that GAO just made?

Ms. UTGOFF. GAO's figures were based on the end of last fiscal year. Since then, we have had an increase in our deficit above the expected level. It is now \$1.7 billion and it will probably go to \$3 billion by 1990.

Chairman PICKLE. All right now. Your prediction is even more severe, dire, than the GAO's. Of course, you can start from the \$1.7 billion level. How do you expect to correct this deficit?

Ms. UTGOFF. There are several alternatives. One is to fix the program so that it does cost \$8.50 or even less.

The second is to go on as we are, charging less than what the program costs and building up a tax that will have to be paid by either future plan participants or future taxpayers.

The third alternative is to raise the premium to the level that is required to put the PBGC back in some kind of financial solvency.

Chairman PICKLE. Do you have any comments on that, Mr. Brauer?

Mr. BRAUER. No, Mr. Chairman.

Chairman PICKLE. In a broader sense, why are these plans underfunded now? What is the primary reason for being underfunded?

Ms. UTGOFF. There are two reasons that come together. Most of the plans that we see that are underfunded are plans in trouble. That is not the only reason. The most important reason I believe is that the PBGC is there.

Chairman PICKLE. PBGC is what?

Ms. UTGOFF. It is there, that employers can make promises that they don't intend to keep, and the employees take those promises seriously because we are there to back them up. I think the Allis-Chalmers case provides very good evidence that that is in fact the case, that there will always be employers who get into trouble. There will be some employers that will be meatpacking, some employers in steel. There will be different industries in the future.

The way the system works now, industries that get into trouble will go to their pension plans as a source of financing, as I said before. So you need the occurrence of two things. The insurance system backing them up and the financial distress.

Chairman PICKLE. You disturb me when you say one reason that these plans are underfunded is that the fact PBGC is there. It is in existence and, therefore, employers say we can dump this liability, or we can avoid it or not pay it, or we can ask for a waiver. No matter what happens we can expect the PBGC to take over.

You are saying then that there will be some question whether PBGC serves a good purpose or not?

Ms. UTGOFF. Yes, I have that question.

Chairman PICKLE. Are you saying that we might do as well if we didn't have the PBGC, our own insurance company?

Ms. UTGOFF. I think the PBGC performs a very, very valuable function. It also does other things that cost a great deal of money. We should cut back PBGC to perform the functions for which Congress intended, which is protecting pension security. Most of what we do is not protecting pension security, it is running a subsidy program, an industrial welfare program that hands out money to troubled companies. That is why the program costs so much, it is not really protecting pension security. We can protect pension security at less than \$8.50.

Chairman PICKLE. How can we do that? Your statements are very interesting to me. I can see why there would be a feeling of the employer, if he is in trouble, and doesn't want to put money into the plan, he may need to put it in some other area, as they choose to do, he could just say if we get in trouble or go under, PBGC will bail us out. There is a feeling of some employers that if worse comes to worse, they still can let PBGC handle it.

That raises a question. By your own statement, you question the value of PBGC from that standpoint. On the other hand, it does serve a useful purpose. What we need to know is how either to keep the PBGC and correct its funding problems, or do away with it. Isn't that your choice?

Ms. UTGOFF. Yes. The PBGC performs a very valuable function when an employer gets into trouble and a pension plan gets into trouble at the same time, through no fault of the employer. Unpredictable changes in the market, and unpredictable changes in the economy, which lead to an employer, through really no voluntary choices, being liquidated, and he doesn't have enough money in the pension plan, even though he has been funding this pension plan

reasonably—that is what the PBGC should be in the business of protecting.

Chairman PICKLE. Mr. Brauer, do you agree with that?

Mr. BRAUER. I certainly think that that is the basic function of the PBGC, yes indeed.

Chairman PICKLE. Well, I find this raises very interesting questions for me.

One more question before you go. Do you think with respect to these premiums, we should get into any kind of risk-related premium structure? That is, should we consider some kind of risk-related premium increase procedure?

Ms. UTGOFF. SEPPAA called for a study of risk-related premiums. We are now conducting that study. It will be submitted to the Congress in the very near future. I believe that a risk-rated premium deserves serious consideration.

Chairman PICKLE. Do you have a comment on the risk-related premium concept?

Mr. BRAUER. No.

Chairman PICKLE. Well, Dr. Utgoff, how many years have you—that is the PBGC—been studying the feasibility of risk-related premiums?

Ms. UTGOFF. I have studied risk-rated premiums myself and for the PBGC.

Chairman PICKLE. Well, first, yourself.

Ms. UTGOFF. The two are different. I have only been at PBGC about 10 months. I have studied risk-related premiums for government insurance programs through much of my own professional career, for employment insurance and for FDIC and I am very interested in it for the same reasons for the PBGC. The PBGC has been studying risk-rated premiums for a number of years and that issue has been around virtually since the inception of the agency. When the premium was \$2.60, I should point out, a risk-rated premium had a great deal of administrative costs, and not much of the benefits of it, because you couldn't spread out \$2.60 very much. So there was less of an incentive to move toward risk-rated premiums when the premium was \$1 and then \$2.60. Now that the actual premium is \$8.50 and the required premium is even higher than that, it is time to reexamine a risk-rated premium and see what its costs and benefits are.

Chairman PICKLE. It seems to me that both IRS and the PBGC, and the GAO, are in general agreement, that the underfunded premium employer plans, are in jeopardy today, and because a few of the companies with a large number of employees have allowed their premiums to be both waived and then go out of business, that you are now faced with a huge deficit of some \$3 billion, even if you make no corrections or changes. That being the case, there is a general agreement on all parts of that, so then the Congress must act and we have no alternative but to take some strong actions in these single plans.

Your testimony today is very helpful because some of you made some generalizations and some specific recommendations. We are going to ask our committee to look at these recommendations and to study your testimony, and too in turn, tell you that we are going to be working with the authorizing committee to determine what

can be done to make these plans more secure. It seems to me like the welfare of the participants and the program itself is going to require that some drastic changes be made.

I would hope that in the meantime that you give us specific recommendations, not just to the authorizing committee, but to this committee, because at some point, no matter what that committee recommends, if it involves a matter of increasing the premiums, it has to come through this committee. I just say we are facing a crisis in the funding program and I think you will see this committee taking further action.

Let me ask, before I conclude, my statements or comments, if Mr. Donnelly has any questions.

Mr. DONNELLY. Thank you, Mr. Chairman.

Mr. Brauer, I sent you a letter back in April regarding a constituent of mine who had been employed for 44 years by a company in my district, had contributed to that company's pension plan for 44 years, retired January 1, 1985, and has not received one single penny for over a year and a half from that company. Aetna is the participating agent in the plan and this company has not met minimum funding requirements since 1978. Aetna has reported to the IRS its failure to meet minimum funding since 1978. It is my understanding the company has applied for a waiver.

I guess my question is, what is the usual procedure when the IRS is notified a company has failed to fund its plan adequately?

I can't get into the specifics of the individual or the company. We have some privacy questions I may ask, generic questions.

Mr. BRAUER. Yes. As you indicated, we cannot get into specifics on that case but I would be happy to ask Mr. Yednock, who is most familiar with our waiver program to give some information if that is what you would like.

Mr. YEDNOCK. In response to your question, when plans are not meeting the minimum funding standards, and this information is uncovered, either through annual reporting requirements or from some other source, that comes to a—

Mr. DONNELLY. This specific plan hasn't met the annual funding requirements since 1978, for 8 years. It has been reported to IRS for 8 years.

Mr. YEDNOCK. In cases such as that, generally we will work through our examination program and audit, and we will go out and assess the taxes due for failure to meet minimum funding. There was a question earlier about the case where an employer has failed to meet the minimum funding standards but has applied for a funding waiver. In a case where there is a bona fide request for a funding waiver, then the field would not go out and assess while the funding waiver request was being processed. So in a case such as that, there would be a delay in actually assessing the taxes for the underfunding while the waiver was being processed.

Mr. DONNELLY. How long does it take to process the funding waiver?

Mr. BRAUER. We had indicated earlier we believe the average is—we are going back to check it out—is approximately a period of several months. Let me also mention—

Mr. DONNELLY. It is not 8 years?

Mr. BRAUER. That is correct. Let me also mention, for your information, that we do have built into our examination procedures, the automatic selection of cases for examination where the minimum funding standards deficiencies exceed a certain amount. That amount is confidential, but above that amount, we do automatically examine cases and that is built into our procedures.

If, on the other hand, the deficiency in a plan does not exceed that amount, then the plan may or may not be examined, depending on our coverage for the year and the number of plans we have happened to examine. But we do indeed have procedures that attempt to ensure that the most egregious situations are automatically looked at and that portion of the remaining situations are examined also.

Mr. DONNELLY. I still can't understand that if the IRS has been notified by the insurer every year since 1978 that the plan has been underfunded, and the individual that owns the company decides to file a waiver, why a situation like that, firstly, isn't acted on expeditiously, because the first thing that comes to my mind is the waiver application is being filed because the wolves are at the door, because the individual who owns the company refuses to put any money into the pension system.

And I guess the question is, who do we represent here? I mean, what is the prime responsibility of the IRS? Is it to the company or is it to the individuals that contributed to the pensions?

Mr. BRAUER. I think we have a responsibility to everyone. Certainly we indeed have a responsibility to the participants, and when matters of underfunding are brought to our attention, then within the limitations of our resources, we do our best to resolve those matters.

Mr. DONNELLY. What enforcement tools does the IRS lack?

Mr. BRAUER. What tools do we lack?

Mr. DONNELLY. Yes.

Mr. BRAUER. Well, basically we have the tools we need. We have agents that go out and do examinations. Obviously we do not have anywhere near 100 percent coverage of the area.

Chairman PICKLE. In that connection, you say you have the resources. How many plans have you investigated for funding deficiencies?

Mr. BRAUER. In fiscal year 1985, Mr. Chairman, we examined approximately 5 percent of that portion of the defined benefit plans that are subject to the minimum funding standards and that corresponds to approximately 7,000 examinations that we would have done.

Chairman PICKLE. Now, in how many cases of those examined did IRS assess a penalty?

Mr. BRAUER. I would have to go back and get that information, Mr. Chairman.

Chairman PICKLE. I understand that. Give me some estimate. Normally do you give a penalty?

Mr. BRAUER. Well, there are some. I don't have an estimate, but there are some situations where the organization itself would voluntarily pay the penalty, of course. There are other situations where based on our examination, we would in effect require the organization to pay a penalty. But I do not have a figure for you, Mr.

Chairman. I will be happy to go back and see if there is one. IRS assessed a tax in 543 of the 7,000 examinations.

Chairman PICKLE. Well, one last question. In that connection, how many people do you have in your department now that investigate these funds? Do you have 10 people; do you have 20 people; 100 people? How many people do you have? Do you have enough resources?

Mr. BRAUER. Are you referring to the waiver?

Chairman PICKLE. Well, when you examine the question of a plan's funding deficiency?

Mr. BRAUER. We have a total of 307 agents in our field offices that do examinations on pension plans. Not all of those in any given year would do examinations of minimum funding standards cases. But the 7,000 figure for examinations that I mentioned earlier, I would have to find basically the average number of hours spent on each case to give you an answer to the question, Mr. Chairman, as to how many actual staff years we would use examining minimum funding standards situations.

Chairman PICKLE. You do not need extra personnel, you have sufficient personnel?

Mr. BRAUER. My impression is that at the present time we are able to handle the situation. I have some degree of confidence that within our resource limitations we do a fairly effective job in the minimum funding standards area.

Mr. DONNELLY. Did I hear you say, Mr. Brauer, some organizations voluntarily pay the penalty?

Mr. BRAUER. Yes. There is a form that is used, 3530 form. Some organizations indicated underfunding situations and wind up paying the 5-percent first tier penalty on their own.

Mr. DONNELLY. What percentage of the organizations?

Mr. BRAUER. We do not have a breakdown as to which voluntarily pay and which do not.

Mr. DONNELLY. What procedure do you have to prevent organizations, companies, and corporations from filing for a waiver to postpone liability?

Mr. BRAUER. Well, I will ask Mr. Yednock to comment further. It is my understanding the filing of a waiver request does not have the effect of postponing liability.

Mr. YEDNOCK. Well, the filing of a waiver request would only postpone the assessing of the tax. The tax is imposed under law and imposed at the time that an accumulated funding deficiency would arise. A bona fide request for funding waiver, where there is hardship, where there is a reason to believe that the employer may either have now or will develop in the future the wherewithal to maintain this plan, will stay the assessing of the tax by our field people. But if there is not a bona fide request for a waiver submitted, that request will be expeditiously closed and then the normal field procedures will take over.

Mr. DONNELLY. I wish I could discuss the specifics of this case, because frankly it is an outrage. I would like to know how any of us, any Federal employee or Member of Congress, would like to work for the Federal Government for 44 years, contribute their hard earned money into a pension system, retire and then have to wait 1½ years and still receive not one single penny, have the in-

surer notifying the Government for 8 years, on a yearly basis, that the company that that individual worked for was not meeting minimum standards, and have the Government frankly do absolutely nothing until the wolves are at the door, then they file for a waiver to keep the wolves away from the door a little bit longer.

I would say, Mr. Chairman, that instances like this will undermine the confidence the American people have in our private pension systems and there will be a firestorm of outrage from people if there is a growing sense the money they are contributing is not going to come back to them not just in due time, but at all.

This good man could be dead and buried before this case is settled. Frankly, up until this point, I haven't been satisfied with the three governmental agencies responsible. The Department of Labor refused to take the individual case. They said we will only take a group of people with problems to litigation. I guess we can't represent individuals, we can only represent groups.

I am anxiously awaiting a decision from the IRS. Do you have any idea or is there anything I can forward to my constituent in terms of time, that we will be hearing when IRS will be making a decision on this one individual?

Mr. BRAUER. I am afraid I really can't give any further information, Mr. Donnelly.

Mr. DONNELLY. Well, you state in your letter to me that you are forwarding my complaint and my constituent's complaint to responsible IRS officials for appropriate action. Can you tell me who the responsible IRS officials are? Or is that a secret too?

Mr. BRAUER. Basically, Mr. Donnelly, as we indicated in the letter, we would be more than happy to discuss and reveal the facts of this case if we had the appropriate request from the chairman of the—

Mr. DONNELLY. You are not answering. I am asking a question. In your letter in response to me—and I quote: "We are forwarding the concern for Mr. Blank, forwarding your complaints against company blank, to responsible IRS officers for appropriate action."

My question is, where did you forward my concern about Mr. Blank and my complaint against company blank. To what IRS officers?

Mr. BRAUER. To give you a specific answer to your question, unfortunately might indicate how the case is proceeding if at all, and I really cannot, unfortunately, answer the question.

Mr. DONNELLY. The case is proceeding because you have to make a determination about the funding waiver. You told me the case is not proceeding at all.

Mr. BRAUER. I am saying I just can't discuss it any further at this particular occasion. I am sorry.

Mr. DONNELLY. Well, Mr. Chairman, I intend to work with you on legislation to prevent any American from being treated in such an arbitrary way when you are dealing with their financial security in their retirement years. It is an outrage that an individual has to wait 1½ years to receive one penny from a participatory pension system and have Government agencies notified on a yearly basis for 8 years that the company was not participating to a minimum standard, and we still have to wait for an answer.

I mean, even if the answer is you are going to allow the waiver, the individual is not going to get any money, any pension benefits. I think the individual at least deserves an answer, then it would be up to the Congress to take some action from there on in.

But just for the sake of fairness, this individual deserves an answer. He and his compatriots around the country deserve some protection from this institution to have Federal law being used to circumvent companies' responsibilities to fund pension systems is very frankly outrageous and the growing lack of confidence in the Government's ability to protect people's affairs will only be further eroded when instances like this become public.

I can understand why people resent our Government, because frankly, after having myself danced around the circle for 1 year on this case, I kind of resent it also.

I will yield my time.

Chairman PICKLE. Thank you, Mr. Donnelly.

The committee is going to submit to both of you additional questions that we would like you to respond because we cannot ask all of the questions we would want. Again, I want to make the observation that our questions may seem to be a bit testy and our responses have also been testy. It seems to me that—

Mr. DONNELLY. The questions should be testy. We are talking about people's entire retirement fiscal affairs.

Chairman PICKLE. I agree.

Mr. DONNELLY. And it is very difficult to look people in the face and say, I know you contributed for 44 years, I know you went to work everyday, paid your taxes, obeyed the laws, but I am sorry, you are not going to get a penny of your own money back, never mind what your company should have contributed. I am sorry, the Government can't help you.

We will send you off to the Department of Labor. They won't litigate the case because you are an individual.

The IRS has been notified for 8 years that this company has not met the minimum funding benefits, but they just field for a waiver so there is nothing we can do for you for 1½ years.

Well, the constituents get a little testy, Mr. Chairman, and I don't think we should be anything but testy and vigilant in protecting people's retirement plans.

Chairman PICKLE. I agree with you. I am making the point that it is time that we ask some hard questions. I think the replies we received or didn't receive are an indication that a lot more needs to be done. We are facing a situation where it is obvious that our deficit now is going to double within the next 5 years if we don't do anything. I, for one, believe we didn't get enough answers from the IRS. You have danced around this issue about the number of people involved in funding issues and you state you have plenty of resources. We are going to ask for more information to see.

Dr. Utgoff makes a good observation that we have got to examine the PBGC. Does it really serve the purpose we set it up to do? If it can't, then we ought to improve, reshuffle, or make changes. We are facing a national crisis here on these unfunded private plans and I think both PBGC and IRS have done business as usual and Congress has allowed it. The participant is not getting protection.

I think changes can be made. That is why we are holding this hearing, to find out what we can do. We ask then for your specific recommendations of steps we should take.

We thank you all very much for your testimony.

Ms. UTGROFF. Thank you, Mr. Chairman.

Chairman PICKLE. Our next panel will be Dallas Salisbury, and Norman Losk. Mr. Salisbury is the president of the Employee Benefit Research Institute [EBRI], which we know much about and hear so much about. Mr. Losk is chairman of the Pension Committee of the American Academy of Actuaries.

First, we will be pleased to hear from you, Mr. Salisbury.

STATEMENT OF DALLAS L. SALISBURY, PRESIDENT, EMPLOYEE BENEFIT RESEARCH INSTITUTE

[The prepared statement begins at p. 65.]

Mr. SALISBURY. Chairman Pickle, thank you. I want to commend you for your continued pursuit of the policy issues surrounding the Nation's retirement income system. In fact, given the current decline in interest rates, and the increase in liabilities for both plans and PBGC, this hearing is particularly timely.

As a result, we are restricting our remarks to the question of underfunding of pension plans, as you requested. Whether you believe the private pension system is adequately funded or not, will depend to a very large extent on the manner in which you choose to view the liabilities associated with pension plans.

Recently most press attention has focused not on liability but on assets. They focus on the fact that the overall private pension system has accumulated well over \$1 trillion in assets, that stand behind the claims to benefits made by active participants and beneficiaries. This constitutes the largest single funding source of pensions in the world and adds considerably to the security of benefit promises under private plans.

The adequacy of funding, as has been noted by other witnesses, can be measured either against the liabilities present, if the plan were terminated, or against the additional liabilities which will accumulate if the plan is maintained on an ongoing basis.

Corporations will be required to report both of these numbers in their future financial statements under rules issued by the Financial Accounting Standards Board. Available data indicate that on average, termination basis funded levels of pension plans have risen over the last several years. Our analysis of various surveys points to rising percentages of plans—in 1985, 78 percent—that are sufficiently funded on a termination basis.

I must add a footnote here that with tremendous declines in interest rates over the last 18 months, these funding figures are likely to deteriorate significantly by the next reporting period.

Mr. SALISBURY. As far as the magnitude of the current unfunded liabilities measure on a termination basis against the 1,500 largest corporate pension plans at the end of 1985, that aggregate unfunded liability was estimated at \$23.4 billion, as compared to \$75.3 billion at the end of 1978.

The ratio of assets to accrued liabilities improved from a 70-percent ratio in 1978 to a 95-percent ratio in 1985. I must again add

the footnote that with interest rate declines now in the marketplace, these ratios are also likely to decline in the current period, and the immediate period ahead should interest rates continue to decline.

Unfortunately, there is no general plan-sponsor data available on a universal basis for private defined benefit plans and their current liabilities. Although in the next several years, some data will emerge from the Financial Accounting Standards Board, it is yet to be seen how useful or valuable it will be.

Ongoing liability which will be reported on that basis, it must be noted, almost always exceeds termination basis liability. Consequently, ongoing liability is more likely to be less than fully funded, and instead of a 95-percent ratio, we are likely to see significantly less on this ongoing plan basis.

I must stress the importance of lack of—absence of—good liability data on the pension system. I would stress it, noting the information provided by Kathleen Utgoff, from the PBGC.

If one looks at the figures they provided, the interest rate on which they were calculated, at the end of 1985, and the interest rate drop since then, those liabilities may in fact already be as much as \$250 million greater than the \$1.7 billion figure that she noted, purely as a result of interest rate fluctuations, having nothing whatsoever to do with liabilities of terminating plans.

The economic causes of underfunding, ironically, a valued part of ERISA, PBGC, creates an incentive for some employers to underfund their pension plans, knowing that any unfunded liabilities can be shifted to the PBGC upon plan termination.

The flat rate premium reinforces this incentive effect. I would agree with Dr. Utgoff that that does not argue that the PBGC should be eliminated, but it does note the degree to which it plays into the funding decisions of plans.

Second, studies confirm that companies in financial difficulty are the most likely ones to underfund a pension plan and shift risk to the PBGC. The termination experience of recent years shows that as well.

Third, companies can control the flow of money into pension funds because of the flexibility ERISA allows in amortizing plan liabilities. Many plans have continued giving benefit increases after plan funding has begun to deteriorate and can fund these increases over 30 years, and in some cases, over as much as 40, if special waivers are granted.

Yet, this flexibility is one of the primary reasons public and private employers have been willing to sponsor defined benefit pension plans, and that flexibility and its relationship to promises must not be overlooked.

In terms of data on amortization, fully 71 percent of the Nation's 1,500 largest companies fund past service liabilities over 20 years or more, 42 percent of plans over 30 years, and 13 percent actually fund at more than a 30-year amortization.

Fourth, declining employment in certain industries may also lead to underfunding, since the declining ratio of participants to beneficiaries increases the employer's pension costs, particularly if the plan has not been fully funded to that point.

In conclusion, Congress imposed funding standards upon employers to improve the security of pension benefit promises. Overall, the standards adopted by the Congress have clearly achieved that goal.

Despite the generally favorable picture, however, the current rules still allow a minority of individual firms to underfund their plans. Basically, this is because ERISA allows considerable flexibility in choosing the period for amortizing the funding of plan liabilities, which is in turn closely related to funding levels.

Funding waivers available to firms experiencing substantial business hardship also allow plans to underfund.

In a final note, I reemphasize, the continuing decline in interest rates and its resulting increases in plan unfunded liabilities make the timing of this hearing particularly important. As evidence, I might provide one example on the effect the interest rate decline might have.

In July of 1985, as you might recall, United Airlines announced the termination of its defined benefit pension plan. At interest rates in the market as of July 1985, they would have obtained a reversion of approximately \$960 million.

They have recently closed out that termination at interest rates now at market rates of between 7 and 8 percent. As a result of that decline, their reversion, instead of being approximately \$960 million, was only of about \$160 million, as a result of the effect on liabilities of that interest rate decline.

Had they been at a fully funded basis, that decline would have moved them from fully funded in July of 1985 to severely underfunded today. I think that is a factor to be focused on as we debate the long-term future of the PBGC.

Thank you, Mr. Chairman.

Chairman PICKLE. Mr. Losk?

**STATEMENT OF NORMAN S. LOSK, CHAIRMAN, PENSION
COMMITTEE, AMERICAN ACADEMY OF ACTUARIES**

[The prepared statement begins a p. 75.]

Mr. Losk. Thank you, Mr. Chairman.

A retirement plan is nothing more than a set of promises. The employer under his plan, establishes rules. Individuals who are covered stay in employment long enough to satisfy those rules, will eventually get a benefit.

Now, the question becomes, what is the financial commitment that the employer is making? Obviously, that commitment depends on future experience. The job of the actuary is to evaluate and project that experience using statistical techniques and assumptions, in order to estimate that financial commitment.

In that sense, the actuary's work is similar to the work done by the Social Security Administration in projecting its benefit payouts over time. Using actuarial methods, which Mr. Brauer referred to, the actuary then develops information that hopefully will help the plan sponsor to accumulate assets over a long period of time, so that by the time people retire or are otherwise eligible for benefits, the money will be there to pay them.

The fact of the matter is that such a plan is a long-term endeavor. The benefits of the plan accumulate as individuals work over their working lifetimes. At the same time, actuarial techniques and funding procedures hopefully will accumulate assets over a reasonable period of time to support those benefits.

Those two items, benefit accumulation and asset accumulation, do not always accumulate together. So when the process is cut short, such as by plan termination, there can very well be an imbalance of assets and earned benefit liabilities.

That imbalance can be on both sides of the coin. We know that a substantial number of plan terminations over the last few years have occurred involving reversions of so-called surplus funds to employers.

There are a number of reasons for plans terminating with less assets than are needed to support the benefits that have been accumulated to the date of termination.

I would like now to just mention briefly the impact of Federal regulation on this process. For years, Federal regulation has had a substantial impact on the funding of qualified pension plans.

Prior to 1974, IRS had requirements which had impact on funding. Since 1974, the impact has been even more pronounced. The private pension system in general has improved funding levels substantially over the past 10 years.

This improvement in funding levels has been due to the minimum funding standards, and the fact that the private pension system has been maturing.

In addition to the minimum funding standards, which are a reasonable set of actuarial guidelines in funding retirement plans, I would like to take note that there seems to be developing in recent years attention or a conflict among policymakers, between the considerations relating to appropriate funding of retirement programs, and concern for the revenue impacts of overfunding.

An example would be in House bill 3838. A provision was included which would have assessed a tax on plan sponsors who understate their tax liability by overstating their pension liabilities.

This provision would certainly not encourage the improvement of pension funding. The point I would like to make here, is that this is a many-sided mechanism.

It is very important to share concerns of the type that Dr. Utgoff indicated earlier. Clearly, it is not in the interest of the private pension system to have that system, and the PBGC manipulated. At the same time, it is important that we not, No. 1, penalize plan sponsors who are funding their pension plans appropriately; and second, discourage those plan sponsors from funding appropriately.

Thank you very much. I am happy to take questions.

Chairman PICKLE. First, Mr. Losk, as chairman of the Pension Committee, I enjoyed your analysis or philosophy. Do you have any specific recommendations for the PBGC or this committee for steps we should take?

Mr. Losk. I have no specific recommendations to make at this stage, with respect to this particular problem. I would only indicate to you that in developing solutions to this problem, that we keep in mind the other side of the coin, and the fact that a large percent-

age of employers and plans are well-funded and continue to improve their funding status.

Chairman PICKLE. Well, that is the good news. Our hearing this morning is to try to concentrate on the underfunded aspects of the single-employer plans. Do you have any specifics as to how the related agencies should approach this problem? You heard testimony that the deficit is going to be \$3 billion in the next 5 years.

Part of the problem, they testified earlier, is the level of funding, the premiums paid, the amortization of the plans, and the number of years for which benefits will be available. If you have any recommendations for change, we would like to have your organization's ideas.

Mr. LOSK. My organization has no specific recommendations to make. We feel that a risk-related premium arrangement, which has been suggested previously, and which has some operational difficulties, would be a fairer way to assess premium than a current across-the-board mechanism. As specific solutions are proposed to these problems, we would be happy to provide input on those.

Chairman PICKLE. Well, if you got any specific recommendations about risk-related premium, we would like to have that.

Mr. LOSK. Very good.

Chairman PICKLE. Mr. Salisbury, I have not had a chance to read all your testimony. The testimony, the commentaries, and your publications, in my opinion, have always been very helpful to this whole program. We are going to study your statement with a great deal of concern. I know you are an authority in this field.

Mr. SALISBURY. Thank you, Mr. Chairman.

Chairman PICKLE. I will say this, you are pinpointing your testimony, saying that the ERISA program has got in trouble because ERISA allows considerable flexibility in choosing the period for amortizing funding of plans' liability, because that is related to the funding level.

That is part of your big difficulty with the entire program.

Mr. SALISBURY. If you look, Mr. Chairman, for lack of a better example at the case of Allis-Chalmers, and the funding history of that particular plan, and the fact that they were basically able to turn a plan over to the PBGC with effectively no assets sitting in the plan, and all of that was legal, then it would imply that should a company wish to, I will use the word "manipulate" what is currently in the law, they can clearly do that.

Chairman PICKLE. Are there a lot of companies out there now similar to the Allis-Chalmers?

Mr. SALISBURY. The numbers that are available would indicate that the vast majority of plan sponsors act responsibly, and they do not have that type of situation and take advantage of the flexibility in such a way that it benefits both the plan and the company.

The point at which the manipulation seems to begin to occur is the point at which a given business begins to move into economic decline, and at that point generally, those companies will begin to go through a process of modifying their actuarial assumptions, and amortization periods.

They started out with a 40-year amortization schedule and moved it down to 20 years to the point that things were not going too badly, and by the time they were getting ready to terminate

the plan, they had moved it all the way back out to the 40 years for the pre-ERISA existing liabilities, and those are all actions that must be reported to the IRS per one of the questions you asked earlier.

Is there a way to identify problem situations such that specialized actions could be taken? I think the answer is definitely yes, even under current reporting procedures.

I will go out on a limb vis-a-vis the individuals previously at this table who were somewhat reluctant to answer specific questions. One could argue in my experience of 12 years, that the Treasury and the IRS very frequently spend a good deal too much time looking after the Fisc, after the status of the Treasury and revenue to the Treasury, excise taxes and all, to aid the revenues of the Government as compared to focusing, as the PBGC must, on meeting benefit promises and guaranteeing that benefits are paid.

Chairman PICKLE. I think that is a good observation, and for my information, you gave an example a while ago, United Airlines, and they went from a situation where they thought they would have what?

Mr. SALISBURY. \$960 odd million.

Chairman PICKLE. And at the time it was finally concluded, it had gone down to what?

Mr. SALISBURY. The final reversion as reported by the PBGC was about \$160 million.

Chairman PICKLE. That is a loss of?

Mr. SALISBURY. \$800 million simply as a result of the drop in interest rates in the market.

Chairman PICKLE. Help me. Relate that now to the PBGC.

Mr. SALISBURY. What I am saying is that the PBGC, as a matter of the way they are instructed to do things, values the liabilities of the PBGC on a so-called settlement basis, meaning that on December 31, each year, they take the market interest rate at which they could go out and purchase enough annuities to pay everybody's benefits and say, that is the liability, and if the interest rate and the marketplace varies by as much as 1 percent from one year to the next, the dollar value of that liability could fluctuate, as was testified to by the General Accounting Office, that liability could increase by 24 percent in 1 year, if interest rates drop by only 1 percentage point, simply because of the fluctuation in interest rates.

One of the things that Norm has noted is that the value of funding in plans has improved dramatically in the post-ERISA era. I don't mean to take away from that as a function of responsible behavior on the part of the private sector, but if you look at the history of the PBGC, and of the private pension system, from 1950 until 1984, interest rates never did anything but go up and actuarial assumptions never did anything but go up, and the rate at which PBGC was able to value its liabilities never did anything but go up, including the 1985 annual rate.

The 1986 annual report for corporations, and the PBGC is going to be one of the first years in over 35 years where they are going to have to report those liabilities at lower interest rates, meaning that those rates—the lower rates—could well mean that the liability number noted by Kathleen Utgoff of 1.7 billion could well, as of

today, actually be over \$2 billion simply because of the drop in interest rates that has taken place.

If those interest rates continue to drop, that liability will be even higher. What she noted as a \$5 billion liability 5 years from now is based on today's interest rate. If that interest rate is lower in the 3, 4 and 5 years, then that liability could be significantly larger simply as a result of interest rate fluctuations without regard to any additional liabilities, new liabilities being placed on the PBGC.

And plans could find themselves in the same situation where by the end of 1986 and into 1987, many of the corporations of America that thought they had extremely overfunded pension plans could well find that as a result of interest rate reductions, that their funds are not overfunded.

I will give you one example. I was at a session in New York last week. One company had just finished revaluing. During the prior 12 months, their assets increased by 25.6 percent. If only you focus on the assets, you would say, that is an amazing increase. As a result of the decline in market interest rates over that same period of time, the liabilities of the plan increased by over 37 percent, so that even though their assets did wonderfully, the funded status of the plan deteriorated significantly over the course of that 12-month period.

That is what could happen to PBGC as well, and it is the reason I say the timing of your concern over this issue could not be more appropriate and more timely.

Chairman PICKLE. Well, I find that to be very interesting, and I assure you, our committee will look into that part of it in greater detail.

Mr. Donnelly.

Mr. DONNELLY. You don't work for the Federal Government, do you?

Mr. SALISBURY. I once did, but I don't any longer.

Mr. DONNELLY. In response to a question that the chairman asked you, you stated, and I think we were on the subject matter of manipulation, you stated it was your opinion that the IRS puts the Federal interest in making waiver determinations in greater priority than the plan's interest, is that a correct assessment of what you said?

Mr. SALISBURY. That was my experience when I was in the Government, and as an outside observer, I would say that that is most readily shown by the relatively consistent argumentation between the PBGC and the IRS over whether or not particular waivers should be granted, and over the terms under which they should be granted, yes.

Mr. DONNELLY. I am dealing with a situation, if I could find out the information that one company in my district was granted a waiver eight times, in a period of less than 10 years, which under my reading of the law would be a violation of the law.

Aren't you allowed only 5 in 15?

Mr. SALISBURY. If they did 8 in 8, then my reading of the law would be that it was excessive as well, yes.

Mr. DONNELLY [presiding]. We don't have a lot of time, and I would like both of you to respond to this. It is again a generic question on manipulation.

There is a growing number of people who have been coming forward to me about situations of which I was totally unaware. They say that they have not been receiving their planned benefits. Is there a ball game percentage, or would it be possible through your analysis to tell what percentage of plans are being manipulated, whether they are the smaller or the larger plans?

Have you done any analysis on that, Mr. Losk?

Mr. SALISBURY. We would not have a basis for targeting that. The situation you describe, assuming the individual was vested in that particular plan, their not being in payment status, shocks me, and I would expect that the number of plans who are behaving in that fashion is very small.

Mr. LOSK. I would agree, but again, as Mr. Salisbury indicated, there is no data in that area.

Mr. DONNELLY. Well, I don't really have any further questions, Mr. Chairman, but I would hope that this one instance is not representative of a larger problem. If it is, there will be a firestorm of criticism of the Federal Government. The IRS put the Government's interests, on a scale of 1 to 10—10 being the highest—the Government's interest would be a 10 in this waiver granting situation.

From your experience, how would you characterize their interest in the plan participant?

Mr. SALISBURY. It would not be prudent for me to rate it as 1 to 10, but I would not put it very high on the scale.

Mr. DONNELLY. You are afraid of them, too. Thank you, gentlemen.

If we could convene the next panel, Kenneth W. Porter, chief actuary and manager, actuarial operations, E.I. du Pont de Nemours & Co.; Vance J. Anderson, member, board of directors, Association of Private Pension and Welfare Plans, and employee relations counsel, Mobil Oil Corp., New York City; and Thomas A. Jorgensen, Esq., Calfee, Halter & Griswold, Cleveland, OH.

We will call the individuals as they are listed in the program.

**STATEMENT OF KENNETH W. PORTER, CHIEF ACTUARY AND
MANAGER, ACTUARIAL OPERATIONS, E.I. du PONT de NEMOURS
& CO., INC., ON BEHALF OF THE ERISA INDUSTRY COMMITTEE,
ACCOMPANIED BY JOHN M. VINE, COUNSEL**

[The prepared statement begins at p. 80.]

Mr. PORTER. My name is Ken Porter. I am chief actuary at the DuPont Co., and I am here today to represent the interests of the ERISA Industry Committee, and its members. With me today, to my left, is John Vine of the firm of Covington & Burling. Mr. Vine is counsel to ERIC.

ERIC's members share with the subcommittees a deep interest in the success and expansion of the private pension system. We have been witnessing in recent years a remarkable growth of the private pension system.

We believe that ERISA's funding standards assure a satisfactory rate of plan funding that is consistent with both the need to protect participants and beneficiaries against underfunding and the

need to give employers sufficient flexibility to encourage them to participate in our Nation's voluntary private pension system.

We believe that the Internal Revenue Service has sufficient authority under existing law to enforce the current pension funding standards.

At the same time, current provisions of the Internal Revenue Code, particularly the section 415 limits on benefits and funding, impede sound pension financing. Furthermore, a number of the provisions in the pending tax reform bill would also interfere with the funding of pension plans.

The ERIC membership recognizes the vital role the pension funding standards have in the security of benefits and fully understand the consequences of underfunding. These firms must balance the needs of the retirement policy of their corporation, the retirement policy of the Nation, corporate tax responsibilities, employee benefits, and employee relations responsibilities, the needs of stockholders, and the needs for other investment opportunities.

This is part of a capital allocation problem within the corporation, that is fully reconciled within the framework of needing to provide investment diversification and desiring to provide adequate pension funding.

On the Federal Government side, there is a need to balance the security of the individuals with the need to provide adequate incentive for voluntary participation in the program.

We believe that recent legislation, the Single-Employer Pension Plan Amendment Act of 1986, went a long way toward providing additional enforcement and security for the private pension system.

In addition, SEPPAA has provided enforcement tools on funding waivers. It is our understanding the IRS currently has the authority to bring together all the parties in a funding waiver situation, and seek agreement for an economic security against the waived contribution. This is not mandatory, but the tool is available, and we would encourage its use.

Our concern is not so much with the rate of funding, as with what is being funded; that is, the pension funding objective. IRS has begun to focus on funding objectives in recent years through its review of the adequacy of actuarial assumptions.

The majority of pension plan sponsors are seeking for a reasonable long-term funding objective that will provide for the benefit security of its employees. To do this, they must look for a middle of the road scenario of economic assumptions.

Nobody really expects that these economic assumptions will exactly materialize. They do hope, however, that over the very long term, actuarial losses and gains will tend to offset and that the scenario they have selected will prove to be a reasonable one, taking into account all the various constraints.

Economic cycles occur over a very long term. It is common to experience several years of losses followed by a trend toward gains. Unfortunately, we tend to view pension funding in the short term when we are looking at whether plans are under or overfunded.

This can be shown by the example of the economic cycles we have recently been through. During the late seventies and early eighties with its periods of double-digit inflation, we experienced

very large increases in liabilities at a time when asset yields were disappointing.

In 1976, when most of our membership began complying with ERISA's funding requirements, no one would have anticipated the inflationary impact we would have to go through. It should come as no surprise that a number of underfunded pension plans terminated during that period of high inflation.

Subsequently, however, real earnings, especially over the last 18 months, have reached unprecedented levels. In spite of the fact that interest rates have also declined pushing up liabilities, the level of funding for many plans has increased.

It is our view that in the aggregate, there is less chance today of a plan terminating with inadequate assets than there was in the past, simply because of the current upward volatility in the assets.

You have heard testimony today as to what interest rate and asset volatility can do. Our point here is that pension funding is a long-term undertaking, and there will be economic periods during which the asset levels tend to be inadequate, and other periods where they will tend to be more adequate. Of course, there will always be companies in both extremes.

What about the funding objective itself? We are seeing more and more companies with pension assets that are adequate in total, not only to meet the obligations if the plans were to terminate, but also to exceed what ERISA deems the full-funding limitation.

Once the assets are at that level, those employers cannot get tax deductions for further funding of their plan. Yet, the full-funding limit itself is based in part on ERISA's section 415 limits. This severely restricts the employer from funding toward the probable future limit indexing and the future benefit promise that they are currently making.

Therefore, these employers are tending to discontinue funding while they are at a full-funding limit status, based on a funding objective that is artificially low.

As an example of how this might occur, consider a plan that has historically been funded in a prudent manner, where the employers' interests have been to provide security to their employees and pensioners. Prior to ERISA, they were funding toward benefits that had no section 415 limits, and, therefore they were properly funding toward the benefit promise.

ERISA imposed a limitation on the benefit payments, but by and large, companies were still permitted to fund toward the full pension promise. Subsequently, the 415 limits have been reduced, and the ability of the employers to project the increases to such limits has been prohibited.

As a result, plans that are well funded, and that have assets are over the full-funding limitation, had properly provided funds in the past for benefits that cannot now be paid from those plans because of the lowering of the 415 limits.

If you will, those assets are sitting there, and cannot be used. As employees do retire and properly receive benefit promises in excess of those limits, the company must fund those same promises again, for a second time, through general corporate assets as the benefits are paid.

Employers, solely because of their past prudence coupled with favorable experience, are essentially being assessed penalties for having funded in that prudent manner.

Yet, if a company were to take a slightly lower funding objective, there is likely to be little penalty at all if they have to add a few extra dollars of contribution later.

We, therefore, think that the full funding limits, the section 415 limits, proposed reductions thereto, and the restrictions to access to excess plan assets will tend to discourage sound pension funding over the long term, and diminish the retirement security of our millions of pension plan participants who will retire and depend on these plans for their retirement security.

We urge the members of these committees to oppose these barriers to sound pension funding. We appreciate the opportunity to provide comments.

Chairman PICKLE. The House has a vote now. The members must go and answer a rollcall. The committee will be recessed for approximately 10 minutes. Let me ask, Mr. Anderson, Mr. Jorgensen, can you wait and go through the lunch period, if we come back immediately?

I am anticipating this is a vote on the record or something like that. We will be able to come back. If not, we will get word back to you, so we will be in recess for approximately 10 minutes.

[Recess.]

Chairman PICKLE. The subcommittee will come to order again.

We have just finished the testimony from Mr. Kenneth Porter.

Now we will hear from Mr. Vance Anderson, a member of the board of directors of the Association of Private Pension and Welfare Plans. He also represents the Mobil Oil Corp., New York.

Mr. Anderson.

STATEMENT OF VANCE J. ANDERSON, MEMBER, BOARD OF DIRECTORS, ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS, AND EMPLOYEE RELATIONS COUNSEL, MOBIL OIL CORP.

[The prepared statement begins at p. 87.]

Mr. ANDERSON. Thank you, Mr. Chairman.

I am Vance Anderson. I am the employee relations counsel for Mobil Corp. I am here today representing the Association of Private Pension and Welfare Plans. As the hour is late, I would like to ask that my prepared statement be inserted in the record. I would like to make a few quick points.

Chairman PICKLE. Without objection.

The association shares your concern that unfunded plans to the extent that they represent a threat to the financial stability of the Pension Benefit Guarantee Corporation, and represent a threat that the premium structure of the PBGC might have to be raised dramatically in the future, is probably well worth your attention. We want to work with you in seeing if there is a problem that can be solved by legislation.

I would like to urge you to keep the problem in perspective and point out fewer than 1 percent of the defined benefit plans terminate in any year, and of those that do terminate, over 98 percent of

them are fully funded. So we are dealing with a situation where we have an identifiable problem involving perhaps one-fiftieth of 1 percent of the defined benefit plans in existence in any given year.

We understand that you have to be properly concerned, as we are, that there is a threat implicit in all the other plans that are out there, that they may too, one day, have a similar problem. However, I would like to point out, the extend that we are considering accelerated funding requirements, to the extent that you are considering questions involving taking security in the situation where there might be a funding waiver, that those are both solutions that affect the one-fiftieth of 1 percent as well as affecting the other 99 percentage points of the plans that have to go about their business on a day-to-day basis and apparently pose no dire immediate threat to the PBGC.

We would like to suggest to you that accelerated funding may be a solution that is worth considering by this committee. We would also like to point out to you, Mr. Chairman, that this committee is properly mindful of revenue considerations and when this committee has had its revenue hat on, it has seen fit to slow down funding to these defined benefit plans consistently in actions it has taken since 1981.

You will note in our testimony we have raised the question of effect the 415-limit reduction might have with regard to permitted levels of funding of these benefit plans. The point here, Mr. Chairman, is that our inability to project income levels in excess of the current DB limit under the 415 limit, in terms of considering what our true cost of operating the plan is for any single year, deprives us of the ability of recognizing the actual cost being incurred, and understates the funding obligation of the employer for that year.

This is a problem that is ongoing, it is a problem that we have been struggling with the last 4 or 5 years, it is a problem that will emerge sometime in the future. As we start to see that emerge, let me suggest it this way, that this is a problem that may emerge in the future, as these plans, if they terminate and if they are dumped on the PBGC, you will find reduced levels of funding prevailing.

Finally, let me suggest to you, Mr. Chairman, that we did consider a number of the proposals that you raised in your questions with Ms. Utgoff just a year or so ago in the context of the single employer termination insurance bill. At that time, the question was, should we require security for funding waivers? I believe that the answer that the administration had at that time was that this should be left to the decision of the agencies and my understanding of that is that is the way it came out.

There was also raised the question of whether we should require accelerated funding. I believe at that point, that the Congress judgment was that the accelerated funding on an increased funding commitment was not necessary.

I want to tell you now that our position is so we are prepared to work with you and work with the committee in considering any solutions that are proposed.

Thank you.

Chairman PICKLE. Mr. Jorgensen.

STATEMENT OF THOMAS A. JORGENSEN, ESQ., MEMBER, EMPLOYEE BENEFITS COUNCIL, U.S. CHAMBER OF COMMERCE, ACCOMPANIED BY JAMES A. KLEIN, MANAGER, PENSION AND EMPLOYEE BENEFITS

[The prepared statement begins at p. 90.]

Mr. JORGENSEN. Thank you, Mr. Chairman.

I would first like to introduce on my right Jim Klein, who is with the U.S. Chamber of Commerce, and who is the chamber's manager of pension and employee benefit plans.

My name is Tom Jorgensen. I am partner in the Cleveland law firm of Calfee, Halter & Griswold. I serve as a member of the employee benefits council of the U.S. Chamber of Commerce. Because time is short, I ask permission that my written statement be included in the record, and I would try to summarize some of the most significant points.

Chairman PICKLE. Without objection, your entire statement will be included, Mr. Jorgensen.

Mr. JORGENSEN. Thank you, Mr. Chairman.

First, it is important to understand that it is highly unlikely that at any point in time the assets of a pension plan will precisely equal the accrued benefits under the plan. Thus, a pension plan can either be underfunded or overfunded. Since underfunded plans present risks to the participants and beneficiaries under the plan, the creditors of the employer, the PBGC, and other premium paying plan sponsors, the chamber has long supported initiatives that encourage responsible funding of pension plans and has long opposed proposals that discourage their funding. The chamber is proud of its role as one of the major proponents of the reforms of the single employer pension plan termination insurance system that were recently enacted as part of COBRA.

Unfortunately, we feel that Federal law may actually work to discourage adequate plan funding in certain instances. For example, section 404 of the Internal Revenue Code will not allow an employer to deduct contributions to a pension plan if the employer is funding past service costs at a rate faster than 10 years. This is true even though the plan termination insurance phases in over 5 years, or in many cases, fewer than years.

The funding problem is particularly aggravated in the case of a flat dollar plan—plan where the formula is a dollar amount, such as \$10 multiplied by a participant's number of years of credited service. This type of plan has really been the prototype for hourly paid employees pension plans throughout industrialized America for many years. Since benefits under these plans are not geared to pay levels, benefits in the plan are increased through amendments, and typically in the recent period of heavy inflation, we have seen that these amendments have occurred every few years, with the result that even if the employer funds at the maximum deductible level, let alone on a 30-year basis, the plan will never be fully funded.

In this regard, it is important to remember, that not all benefit increases that are affected by amendments are generated by either the employer or employee representatives. ERISA, the Retirement Equity Act, and the tax reform package currently being considered

by Congress, contain provisions which expand vesting rights and plan coverage and consequently reduce the funding status of existing plans.

For example, the Senate finance tax reform proposal contains revolutionary nondiscrimination rules for pension and welfare plans. To the extent that these rules result in expansion of plans to cover new groups of employees, or increases in benefits for other groups of employees, they will create new pension liabilities which will have to be funded. If a plan is already underfunded, these proposals, along with the 5-year vesting proposal, will make the underfunding worse.

The tax reform proposals also contain new reduction in the limitations on annual benefits under section 415 of the IRS Code and Mr. Anderson addressed those. One of our members has estimated that the 415 cuts in the House bill will affect the funding of the projected benefits of 46 percent of its employees. While those in the Senate finance bill will affect 51 percent of its employees.

From a policy point of view, the provision that we are most concerned about in the tax reform package as it affects funding of plans, is the proposal to impose an excise tax on a reversion to the employer from an overfunded plan. As I indicated earlier, a plan will either be underfunded or overfunded and taxing reversions from overfunded plans, penalizes an employer which has responsibly funded its plan, fulfilled its pension promises, has not been a drain on the Pension Benefit Guarantee Corporation, and other premium payers.

If enacted, such a tax will have a chilling effect on responsible pension funding. Plan sponsors will change their funding practices and policies to ensure that their plans will be underfunded and thus not subject to this tax.

Any excise tax on fulfilling pension promises is extremely bad retirement income policy. The chamber believes that this employee benefit provisions of the tax reform package should not be appendages on a comprehensive tax bill. They should be considered separately, such as this committee is considering the current issue of underfunded plans, in the context of retirement income policy. The chamber strongly urges the conferees to delete them from the final tax reform bill and to consider them as part of the retirement income policy.

On behalf of the chamber I would like to thank you for the opportunity of testifying today and expressing the chamber's continued dedication to encouraging responsible funding of pension plans, and its opposition to proposals that discourage funding.

Chairman PICKLE. Thank you.

Well, gentlemen, I appreciate testimony and all your statements will be included in the record.

I want to point out to you, that the purpose of this hearing is primarily to discuss the problem of the underfunding of single-employer plans and what can we do about them. Most of you have indicated that the problem is a very small problem. You talk constantly about 415 limits and other corrections that might or might not be put in the Tax Code.

I would ask you, though, to more specifically help this committee by stating: Why are the present plans underfunded? What can we

do about it? I can't ignore the fact that the underfunded liability of PBGC is going to double in the next 5 years. One of you said we ought to have an accelerated funding. I believe it was Mr. Anderson. Do you mean by that to increase the premium?

Mr. ANDERSON. I am not an advocate of accelerated funding, although I think it was one of the proposals Ms. Utgoff had for you this morning, to the effect that employers' contributions should be increased to more rapidly fund the liabilities of their plans.

I was trying to point out to you that that is a proposal that was considered by this committee a year or so ago in the context of the single employer reform bill at that time, and was rejected, not because it would not have had a salutary effect on a small number of plans that are terminated, in underfunded position obviously it would have been helpful in those cases had funding been more aggressive in past years.

Your dilemma in that regard I would suggest to you, Mr. Pickle, is that you have got the other 99 percent of the plans out there, and you will be imposing accelerated funding obligations on those plans as well as the plans that—

Chairman PICKLE. Yes.

Mr. ANDERSON. That are terminated. That creates at the very least a revenue dilemma for you.

Chairman PICKLE. Yes. I can recognize that it would cause a disruption or imbalance. The fact is, though, we have got a deficit now and it is going to be doubled if we don't make any changes. We have got to ask ourselves, what can we do to correct that.

Now, dismiss from our mind the concern, perspective or problem you are associated with, for the most part. We have a problem. We have to correct it some way. I am asking for specific recommendations. I have to assume you are concerned about the deficit, as are we and PBGC. I don't see premiums going to the point it will either cause companies to run from it or in the reverse, make you assume the burden. What are we going to do about it specifically? I don't want to acknowledge that you are concerned about the 415 limits, but I am talking about now the deficit. I have the PBGC's idea of and what we can do. Do you have any specific recommendations, any of you, that will help us correct that problem now?

Mr. JORGENSEN. Mr. Chairman, first, I would like for the committee to focus in on a plan that we have identified—the flat dollar plan—and to look at funding of those separate and apart from those plans that base benefits upon final pay.

There are actuarial methods which allow for plans that use pay as a basis, to anticipate and project the benefits that a participant will receive at retirement and fund for that. The effect of that is to allow those plans to be fully funded at any given point in time.

In a flat dollar plan, where you are constrained, you cannot fund past service benefits any faster than 10 years, and in fact, could draw it out as much as 30 years. You have a situation that, unless there is an actuarial windfall, such as an increase in interest rates, or plan assets perform beyond the actuarial assumption, such a plan is required to be underfunded by the current funding rules.

I would suggest that the committee, Mr. Chairman, focus in on that type of plan. Perhaps ask the General Accounting Office, if the types of plans that threw the greatest liability on the Pension

Benefit Guarantee Corporation were in fact flat dollar plans of the nature that I have described.

Chairman PICKLE. Are you saying that instead of a flat dollar amount, we might consider the risk-related premium. Is that what you are saying to me?

Mr. JORGENSEN. I think the chamber would be amenable to a risk-related premium structure, but I am focusing in on the type of pension plan that generates the liability, and there are two types of plans, if I can generalize this greatly. One where the benefit formula is geared to the compensation of participants; the other plan where the benefit formula is simply a flat dollar amount.

An example that certain speakers have used is \$10 times the number of years of service. With that type of plan, the plan sponsor is not allowed to project the ultimate retirement benefit that will be payable to employees and that is the single most important factor that in a pay related plan allows those plans to be fully funded in their lifetime.

Chairman PICKLE. Congress last year passed the so-called COBRA measure in hopes that it would correct some of, or at least make it tougher, on terminations and that type of thing. Has that helped or will that help the funding of PBGC materially? What commentary would you want to make on the COBRA Act?

Mr. ANDERSON. Those changes should have a positive effect but our problem there is that you make a change of that sort and you see an effect 2 years, 3 years, 4 years down the road when you have the ability to see some trend established with regard to the relative liability being assumed by the PBGC over some point of time. When it shows up in the PBGC's bottom line it is probably going to take a few more years.

Mr. JORGENSEN. We would agree with that statement. COBRA should be given an opportunity to show whether or not it will ameliorate the problem.

Chairman PICKLE. We heard testimony this morning indicating though, even COBRA will make changes, we don't know what effect it will have. It takes some time. Even with changes made, they have said our deficit is going to go from \$1.5 up to over \$3 billion. Now, that means we have got to make some fundamental changes. I don't know whether the solution is in the premium rates, in the risk-related premium area, or whether in amortization. Something must be done. While you are concerned about companies that are overfunded and have plans that are in good shape, you need to minimize the 1 or 2 percent of the underfunded plans. The cost is enormous and jeopardizes the entire funding system and the PBGC.

I appeal to you, as we consider these big 415 limitations. I would like for you to also consider how we are going to keep the PBGC from going under.

Mr. ANDERSON. We are going to wind up paying for it in the premiums and we are acutely conscious of that.

Chairman PICKLE. Perhaps so, but as one member, I hope we don't think that is the answer—to keep on increasing the premium—because there are certain unfairnesses to doing that.

Mr. ANDERSON. That we certainly agree with.

Chairman PICKLE. Vis-a-vis the good companies and bad companies. It seems to me like we have to make other changes. Do you gentlemen feel that the waiver program has been abused or is it necessary, or is it working well?

Mr. PORTER. I think, Mr. Chairman, the waiver program, especially as amended by COBRA, hasn't really had the opportunity to prove whether further amendments need to take place. Obviously, in any particular situation, judgments are made, and there are bound to be cases where waivers are granted to plans that ultimately fail.

We do know the IRS has stepped up its efforts concerning reasonable actuarial assumptions. This has been relatively recent, and those effects have not been seen in their full force. We think, obviously, those are not cure-alls for the problems. But, these two things have been happening but have not had a chance to produce results: One is the authority that was granted by COBRA to at least get the parties together and look for some kind of security on waivers; and the other being the IRS stepped up review of actuarial assumptions to ferret out those cases where they truly have unreasonable assumptions.

I think these will go a long way toward correcting some of the problems we have heard about—certainly not all. We should allow those things to operate before we determine whether they are effective.

Chairman PICKLE. Mr. Jorgensen, in the area of waivers, I doubt Mr. Anderson and Mr. Porter would have much experience or background on these waivers, but in your area, I understand that a lot of your companies would be the smaller companies. Does the IRS get a waiver out on time or do they take too long? How are the waiver programs going?

Mr. JORGENSEN. I think prior to the passage of COBRA, the view of many employers was that a funding waiver was perhaps a cheaper or easier form of financing than other alternative forms of financing.

As far as the performance of the IRS, the limited experience that I have had with funding waivers indicates the 2 to 3 months period is an accurate description of the average, at least that I am familiar with.

I am troubled, as an individual rather than as a member of the U.S. Chamber of Commerce, with funding waivers having been granted at a time when benefit increases were allowed to be implemented. In fact, further accrual of benefits was allowed to carry on through the funding waiver period, so that the plan during the funding waiver period became even worse funded, more poorly funded than it was at the time of the funding waiver.

Chairman PICKLE. Could IRS not have granted the waiver when they knew that benefits were being increased? Does IRS have that authority?

Mr. JORGENSEN. I believe they do, sir.

Chairman PICKLE. We didn't get that clear from the IRS this morning.

Mr. JORGENSEN. I know that the Internal Revenue Service imposed conditions upon the granting of funding waivers that have gone beyond the precise wording of the statute. Such a condition

would at least be possible. Now, in many cases, it would have meant renegotiating a collective-bargaining agreement which could have dissuaded the employer from going forward with a funding waiver request had they had to do that.

Chairman PICKLE. Our committee is going to submit questions to you, and we hope that you would give us some response in writing as quickly as possible.

We are concerned about the funding aspects of this PBGC program. The fund is still operable and we have increased premiums. We know if we have a dozen more Allis-Chalmers cases we are in big trouble, and so is your program, as far as it relates to the insurance program we have set up. So we will submit these questions to you. I hope you can respond quickly. I thank you for your testimony.

Mr. ANDERSON. Thank you, Mr. Chairman.

Chairman PICKLE. Now, our last witness is Alan V. Reuther, associate general counsel of the International Union, UAW.

STATEMENT OF ALAN V. REUTHER, ASSOCIATE GENERAL COUNSEL, INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE, AND AGRICULTURAL IMPLEMENT WORKERS OF AMERICA (UAW)

[The prepared statement begins at p. 95.]

Mr. REUTHER. Mr. Chairman, my name is Alan Reuther. I am associate general counsel for the International Union, UAW. The UAW appreciates the opportunity to testify before these subcommittees concerning the funding of single employer defined benefit pension plans. I would ask that my complete statement be included in the hearing record.

Chairman PICKLE. It will be included.

The UAW is proud of the role it has played in the struggle to achieve adequate funding for defined benefit pension plans. The UAW struck Chrysler Corp. for 104 days in 1950 in order to establish the principle that pension plans should be adequately funded. This principle became the standard pattern for UAW negotiated contracts.

The UAW also wholeheartedly supported the enactment of minimum funding standards for all pension plans in title I of ERISA. In our judgment, the minimum funding standards mandated by ERISA have played an important role in assuring that most pension plans are adequately funded.

When Congress enacted ERISA, it recognized that the establishment of minimum funding standards would not be enough to solve the Studebaker type of problem—that is, situations in which workers and retirees lost a substantial portion of their vested pension benefits because a company experiencing severe economic difficulty terminated its pension plan and the plan had insufficient assets to pay all vested benefits. To address the Studebaker type of problem, Congress also provided for the establishment of the pension plan termination insurance program in title IV of ERISA. The UAW believes that the termination insurance program has been largely successful in achieving its intended objectives.

Some persons have raised questions concerning the termination last year of several pension plans with large underfunded liabilities. UAW does not believe that these cases should be viewed as evidence that ERISA's minimum funding standards have failed. Rather, these cases should be viewed as vindicating Congress' original judgment that the establishment of a pension plan termination insurance program was necessary in order to assure that participants and beneficiaries receive anticipated benefits. Thanks to the existence of PBGC, we are able to prevent a reoccurrence of the Studebaker pension tragedy in these situations.

To relieve pressure on the termination insurance program, some persons have suggested that more rapid funding of pension plans should be required in certain situations. In our judgment, this could very well prove to be counterproductive. It could lead to the quicker demise of companies experiencing economic difficulty, which would aggravate the financial condition of the PBGC and undermine the retirement income security of participants and beneficiaries.

The recent enactment of the Single Employer Pension Plan Amendments Act of 1986, has strengthened the termination insurance program. It should also have a positive impact on the funding of pension plans. Congress should wait a reasonable period of time to assess the impact of SEPPAA on the funding of pension plans and the operation of the termination insurance program, before it considers any new legislative initiatives in these areas.

The UAW believes that, in the long run, the only effective way to assure adequate funding for defined benefit pension plans and to relieve pressure on the PBGC is to attack the root causes behind the major plan terminations—namely, the economic and trade policies which have led to a serious decline in the Nation's basic industries. The most salient characteristic of the pension plans with large unfunded pension liabilities is that their plan sponsors are usually experiencing severe economic difficulty, largely as a result of an overall decline in their industries. The problem posed by these large unfunded pension liabilities cannot be solved by tinkering with ERISA's minimum funding standards. It can only be solved by economic and trade policies which will enable the plan sponsors to return to profitability, so that they can continue to maintain their pension plans and meet their funding obligations.

Before concluding, I would like to respond to a number of points that were made by the Pension Benefit Guarantee Corporation earlier today.

The assertion was made that the existence of the termination insurance program itself has aggravated the problem of underfunded pension plans. In effect, that employers and unions have no incentive to fund pension plans, they simply let the liability grow and use moneys in collective bargaining for other purposes.

The Allis-Chalmers case was cited as an example of this. The fact is that this was not the situation in Allis-Chalmers. For some time, the UAW had been giving concessions to Allis-Chalmers in collective bargaining. There were no pension increases at Allis-Chalmers after 1981, so this was not a case where there was continual pension increases while the company was going downhill.

I would also point out that the COBRA provisions have considerably reduced any incentive that employers might have had to let their plans become underfunded. The fact is that the PBGC has been given a much larger claim against employers for any unfunded liabilities.

Now, it is true that the PBGC may not always collect 100 cents on the dollar on those claims in bankruptcy proceedings, but that is the case with any creditor. I believe that the COBRA provisions will have a much bigger impact on encouraging employers to fund than any movement toward risk-related premiums.

As far as changes in the bankruptcy code which was suggested, these could very well prove to be counterproductive. Given the PBGC higher status in bankruptcy proceedings could deprive companies in economic difficulty of much needed lines of credit, and ultimately wind up forcing them out of business sooner.

The PBGC has asserted that there is a need for faster funding of pension plans, and they have cited Allis-Chalmers as a case history for this.

In Allis-Chalmers, PBGC did not press for faster funding of the pension plan. In fact, they were not even willing to step up to try and enforce the minimum funding standards. Allis-Chalmers was scheduled to make a contribution to the pension plan of \$18 million in September of 1985.

With that contribution, the pension plan would have had sufficient funds to pay all promised benefits through the expiration of the contract in January 1986.

PBGC entered into an agreement with the company to terminate the plan prematurely in July 1985, in violation of the collective bargaining agreement. The UAW has brought litigation challenging this termination.

PBGC is now defending that case, arguing the company couldn't afford to meet this pension contribution. They can't have it both ways. They can't come in here and testify that we ought to require more rapid funding of pension plans when, in fact, in cases like Allis-Chalmers, they were are not even willing to insist that the company live up to the minimum funding obligations required under current law.

It is ironic that the PBGC entered into this agreement with Allis-Chalmers to terminate the pension plan prematurely. If they had not done so, the pension plan would have been covered by the new COBRA provisions, and PBGC would have had a much larger claim against the company in the event of a subsequent termination. So the PBGC is partly responsible for aggravating their own financial condition.

Thank you, Mr. Chairman.

Chairman PICKLE. Thank you.

It is too early for us to make an estimation of the effectiveness of the SEPPAA changes. We hope they will be helpful, but we will have to wait to see on that.

In the meantime, though, I am disturbed. If I understood your testimony correctly, you think you are not going to cure this problem on the underfunded programs until you can cure the root causes: the trade and economic difficulties we have in this country.

Now, that sounds good, but we can't make resolution of our funding problems dependent upon solving the trade and economic problems of this country. That might be until kingdom come.

We got to do something to bolster up the PBGC. You are right, they can't have it both ways. Specifically, what are we going to do about the deficit? What recommendation do you make to cure the deficit of the PBGC?

Mr. REUTHER. First, Congress took important steps through the COBRA provisions; and second, the PBGC is not in any immediate danger of not being able to pay benefits, there is no immediate cash flow problem. Therefore, I would say that we do have time to assess the impact of the COBRA provisions.

Chairman PICKLE. That goes on the assumption that the economy moves along smoothly, but if we have a few more Allis-Chalmers, the PBGC is in question.

Mr. REUTHER. The figures that they have given today reflect the fact that you have had the Wheeling-Pittsburgh and Allis-Chalmers terminations. They were the two largest plan terminations in the whole history of the PBGC.

It is not reasonable to expect we will be seeing the same types of experiences in the next few years.

Chairman PICKLE. As a Member of the Congress, I look at those two companies, and say to myself, if we had half a dozen more of those, we would be in big difficulty. You say, well, it is not likely, but we have to try to look at what might happen.

Mr. REUTHER. The most important things the committee can do to prevent more Allis-Chalmers, is to do something about the basic economic causes. This committee and the House have already done something by passing a comprehensive trade bill.

Chairman PICKLE. I hear you, but I set that aside temporarily. How do we shore up this one aspect of a defined benefit? This committee has been charged with looking into and holding this hearing on the unfunded liabilities of single-employer pension plans. We are doing so because the committee chairman has asked us to ascertain what role the pension programs play in the overall retirement policy of the United States.

Now, very few people today have talked in terms of the adequate retirement policy. We really don't have much of a policy, at least not coordinated yet. We need to do a lot more. We can refer, as we often do, to the three-legged stool of private pension plans, company plans, and your own savings. But the biggest part of that stool, if we are going to have fairness, is what do we do about these single-employer funded plans. This is where a lot of people are involved and depend on it.

How do we shore up that program? Make changes? That is what we are looking for. I am not going to argue with you about economic and trade policy, but what do we do to keep more companies from going under?

You are saying we just change the trade policy, but more specifically, what do we do?

Mr. REUTHER. First, we commend the committee for conducting this series of hearings on a national retirement income policy. That is exactly the type of process that this committee ought to be engaging in.

Second, in terms of specifically what can be done in a situation like Allis-Chalmers, as the PBGC indicated in its testimony, the ratio of retirees to actives, active employees, at the time the plan was terminated, was approximately 8,500 retirees to 1,300 actives.

Now, I would submit with a ratio like that, you are going to have a pension problem, and I compare that to the discussion that went on when this committee and the Congress looked at the Social Security system in 1983.

You were one of the leaders in talking about the problems because of the change in the ratio of retired people to active workers. Well, the problem in the Social Security system is small compared to the situation that you had at Allis-Chalmers.

I would submit, when you are faced with a situation like Allis-Chalmers, a drastic shrinkage of the company to the point where the retirees far outnumber the active employees, you will not be able to address that type of a problem by changing the minimum funding standards.

It is not going to work, no matter what you do to the minimum funding standards.

Chairman PICKLE. That is not a very encouraging assessment.

Mr. REUTHER. I hate to say it, because I know it is not what you want to hear, but it gets back to the only way to prevent an Allis-Chalmers type of situation is to get at the root causes. We talked about what happened at Chrysler in 1979-80, they faced economic troubles and a pension problem.

The solution was not to require faster funding, but the Chrysler Loan Guaranty Program, the concessions the workers gave, to enable Chrysler to get back on its feet.

The pension funding is much better now than it was in 1980.

Chairman PICKLE. More specific to the question at hand, what do you recommend we do to try to correct the massive deficit that exists with PBGC now?

Mr. REUTHER. We are not recommending any immediate legislative steps. As I said before, we think a period of time should be allowed to go by to assess the major changes that were already made.

We don't believe there should be a premium increase right now. There has already been a major increase in the premium. We think Congress should give the reforms time to operate, to see if they address the problems.

If they don't, Congress can come back in a few years and make other changes if they are needed.

Chairman PICKLE. Well, as one member of the committee, I am not going to recommend that we wait a few years to see what happens, because it is obvious some changes need to be made, and this Congress won't automatically wait and increase the premium.

We did it this last time with the clear understanding we were going to look into the weaknesses of the program, the overfunding and underfunding. This committee is trying to collect information. We are saying to the authorizing committee, and the Members of the Congress, I don't think this committee is going to grant another premium increase until we can see other corrections are being made in the overall program.

If you have any specific recommendations, data to give us, we would like to have it. We will also submit to you a lot of questions in writing that we would like your response to.

We have asked all the witnesses today, why is the plan underfunded, and we got all sorts of answers. We are going to ask you some of the same questions, and we would like your response as quickly as you can.

I thank you for coming and your patience. You were the last witness today, but we made as much progress as we could as far as we could.

This committee stands adjourned.

[Whereupon, at 1:15 p.m., the subcommittees were adjourned.]

APPENDIX

FOR IMMEDIATE RELEASE
WEDNESDAY, JUNE 11, 1986

PRESS RELEASE #22
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1105 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D. C. 20515
TELEPHONE: (202) 225-5522

THE HONORABLE J. J. PICKLE (D., TEX.),
CHAIRMAN, SUBCOMMITTEE ON OVERSIGHT,
AND
THE HONORABLE JAMES R. JONES (D., OKLA.),
CHAIRMAN, SUBCOMMITTEE ON SOCIAL SECURITY,
COMMITTEE ON WAYS AND MEANS,
U.S. HOUSE OF REPRESENTATIVES,
ANNOUNCE A JOINT HEARING ON
PENSION PLAN UNDERFUNDING

The Honorable J. J. Pickle (D., Texas), Chairman, Subcommittee on Oversight, and the Honorable James R. Jones (D., Okla.), Chairman, Subcommittee on Social Security of the Committee on Ways and Means, U.S. House of Representatives, today announced a joint hearing to examine the underfunding of qualified pension plans. The hearing will be held on Tuesday, June 24, 1986, in the Budget Committee Hearing Room, 210 Cannon House Office Building, beginning at 9:30 a.m.

Background

On February 7, 1985, Committee Chairman Dan Rostenkowski (D., Ill.) requested the Subcommittees on Social Security and Oversight to conduct a comprehensive review of national retirement income policy, focusing on the goals and performance of the current retirement income system based on social security, private pensions and personal savings. (See Ways and Means Press Release #4, dated March 1, 1985.) As a result, information has been gathered and analyses undertaken in an effort to evaluate the coverage, cost and efficiency of the retirement system as it exists today.

Issues

This third hearing of the Subcommittees' review of retirement income security will address the causes and effects of underfunded private single-employer pension plans. The hearing will focus on concerns about continued underfunding of some pension plans and the effect termination of such plans has on the viability of the Federal single-employer insurance program.

In February, Chairman Pickle requested that the General Accounting Office (GAO) undertake an examination of this issue, with particular focus on the characteristics of terminated plans, and the relationship between the actual level of plan contributions and Employee Retirement Income Security Act (ERISA) minimum funding standards. The Subcommittees will receive testimony from the GAO, the Internal Revenue Service (IRS), the Pension Benefit Guaranty Corporation (PBGC), and other invited witnesses interested in these issues. Witnesses will provide information and their views on the following questions:

1. What are the characteristics of underfunded pension plans and sponsoring employers?
2. How do such plans become underfunded?
3. What is the role of the minimum funding standards of ERISA?
4. What impact does underfunding have on plan beneficiaries generally and the PBGC in particular?
5. Are plans better funded today than in 1974 when ERISA was enacted?

6. What has recent legislation done to address the causes and consequences of underfunding?
7. What should we expect in the future with regard to the funding of plans?
8. What problem areas merit further consideration?

Details For Submission Of Written Comments

Persons wishing to submit written comments for the printed record of the hearing should submit six (6) copies by the close of business, Monday, July 28, 1986, to Joseph K. Dowley, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, Room 1102 Longworth House Office Building, Washington, D. C. 20515.

SEE ENCLOSED FORMATTING REQUIREMENTS.

**COMMITTEE ON WAYS AND MEANS FORMATTING REQUIREMENTS FOR PRINTING
OF HEARING STATEMENTS, WRITTEN COMMENTS AND EXHIBITS**

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

****** NOTICE -- CHANGE IN LOCATION ******

FOR IMMEDIATE RELEASE
FRIDAY, JUNE 20, 1986

PRESS RELEASE #22-REVISED
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1105 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D. C. 20515
TELEPHONE: (202) 225-5522

THE HONORABLE J. J. PICKLE (D., TEXAS),
CHAIRMAN, SUBCOMMITTEE ON OVERSIGHT,
AND
THE HONORABLE JAMES R. JONES (D., OKLA.),
CHAIRMAN, SUBCOMMITTEE ON SOCIAL SECURITY,
COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES,
ANNOUNCES A CHANGE IN LOCATION FOR THE JOINT HEARING SCHEDULED FOR
JUNE 24, 1986, ON PENSION PLAN UNDERFUNDING

The Honorable J. J. Pickle (D., Texas), Chairman, Subcommittee on Oversight, and the Honorable James R. Jones (D., Okla.), Chairman, Subcommittee on Social Security of the Committee on Ways and Means, U.S. House of Representatives, announced a change in location of the hearing on Pension Plan Underfunding. The hearing, scheduled on June 24, 1986, at 9:30 a.m., will now be held in the main Committee hearing room, 1100 Longworth House Office Building.

All other details for the hearing remain the same (see Press Release #22, dated June 11, 1986).

PREPARED STATEMENTS OF WITNESSES

JOSEPH F. DELFICO
SENIOR ASSOCIATE DIRECTOR
U.S. GENERAL ACCOUNTING OFFICE

Mr. Chairmen and Members of the Subcommittees, I am Joseph Delfico, Senior Associate Director, in-charge of Income Security matters in the General Accounting Office. I am pleased to be here today to discuss private pension plan underfunding.

In 1974, the Employee Retirement Income Security Act (ERISA) established funding standards to help ensure that assets of defined benefit plans were adequate to pay promised pension benefits. The act also set up a government insurance program, administered by the Pension Benefit Guaranty Corporation, to guarantee, within certain limits, benefits of single employer plans not funded by employers at plan termination. About 30 million people are now covered by 110,000 insured plans. The insured plans finance the program through annual premiums.

Between ERISA's enactment and the end of fiscal year 1985, 68,000 insured plans terminated. About 1,100 of these plans, covering about 160,000 insured participants, filed claims against the insurance program because they were underfunded, that is, they did not have enough assets to pay guaranteed benefits. Claims have exceeded premium revenues from ongoing plans, causing the insurance program to operate at a deficit. The program's estimated deficit at September 30, 1985, was \$1.3 billion (liabilities of \$2.7 billion minus assets of \$1.4 billion). The Single Employer Pension Plan Amendments Act of 1986 was designed to help avoid or reduce claims, and improve the program's financing.

I would now like to provide information and observations on plan underfunding and its effects. This information has been developed in response to your February 12, 1986, request that we study underfunding and associated trends in insurance claims. My testimony focuses on plan underfunding, its extent and effects, factors contributing to underfunding, the potential of the 1986 amendments for alleviating the effects of underfunded terminations, and alternatives for controlling underfunding and its effects.

EXTENT OF PLAN UNDERFUNDING

We analyzed the funding status of large single employer plans (100 or more participants) using the government's latest and most complete plan data (1983) as of November 1985. We considered a plan to be underfunded if the value of its assets was less than the estimated value of participants' earned benefits. Most of these benefits would have been guaranteed by the insurance program if the plans had terminated.

We found that most plans in 1983 were overfunded, but many were underfunded and some by large amounts. Of the 14,500 plans reviewed, over 2,300 (16 percent) were underfunded by more than \$18 billion. These underfunded plans covered almost 4 million (21 percent) of the 19 million participants. In contrast, over 12,200 plans with 15 million participants were overfunded by about \$87 billion.

We also found that the bulk of the underfunding was concentrated in a relatively few plans. Over 90 percent of the total underfunding was in 275 plans that were underfunded by \$5 million or more each. Six plans alone had a total of \$7 billion in unfunded benefits. In addition, one out of every five underfunded plans was less than 50 percent funded.

FUNDING REQUIREMENTS AND BENEFIT GUARANTEES

Generally, ERISA's funding standards were established to help ensure that plans accumulate enough assets to pay benefits

as participants retire. Actuaries value plan assets and benefits under any of several acceptable funding methods to determine annual minimum contribution requirements under the standards.

Plans may be underfunded at termination for various reasons. Some funding methods result in slower asset accumulation than others. Also, minimum contribution requirements are based on the assumption that the plans will continue rather than terminate and, therefore, on assumptions about future conditions affecting plan assets and benefit liabilities. The plan's actual experience may differ from these assumptions.

Plans may also be underfunded if they terminate before employers make contributions for a particular plan year. Contributions are not required until 8-1/2 months after a year ends. Also, the Internal Revenue Service (IRS) can waive required contributions because of business hardship.

In addition, benefit increases that allow credit for participants' past years of service (e.g., cost-of-living increases for retirees) can create or add to underfunding. Because these increases are permitted to be funded over periods as long as 30 years, plans that grant them (especially those that grant them frequently) can terminate with substantial unfunded benefits.

The insurance program generally guarantees, at termination, plan benefits to which participants have a nonforfeitable right (vested benefits). However, the guarantee of benefit increases is limited to help protect the program. Generally, increases in effect for less than 5 years before termination are insured after each year at a rate of 20 percent of the increase or \$20 per month, whichever is greater. By contrast, the Corporation's insurance program for multiemployer plans does not insure any benefits attributable to increases until they have been in effect for 5 years.

EFFECTS OF PLAN UNDERFUNDING

Plan underfunding adversely affects the insurance program when plans voluntarily terminate with large amounts of unfunded benefits that cannot be recovered from sponsoring employers. The program's large deficit is a direct result of a rising trend in the size of claims. These claims have come from relatively few employers. For example, during fiscal years 1983 through 1985, 23 employers terminated 33 plans that accounted for \$450 million in claims (90 percent of total claims in the period). Of these claims, the Corporation expects to recover \$64 million (14 percent) from the sponsoring employers. Premium payments from ongoing plans will have to finance the remainder.

Permitting plans to be underfunded results in some employers granting immediate pension benefit increases and funding them over time. Such increases, which might not otherwise be affordable, help to protect participants' pensions against inflation.

As long as employers eventually pay these unfunded benefits, or the insurance program remains viable, plan underfunding has a negative impact on few participants. For example, 4,000 participants in the 33 terminated plans lost earned benefits because they were not vested and, therefore, not guaranteed by the insurance program. The other 31,000 plan participants, however, were vested and generally assured of receiving most earned benefits because they were guaranteed.

FACTORS CONTRIBUTING TO PLAN
UNDERFUNDING AT TERMINATION

We reviewed the funding practices for the 33 plans that resulted in 90 percent of the claims against the insurance program during 1983 through 1985. Our review was limited to the 5-year period before plan termination because earlier data were generally not available.

We found that most of the 23 employers sponsoring the terminated plans were experiencing business hardship during the 5 years before termination. At plan termination, 17 of the employers were in bankruptcy reorganization or liquidation proceedings.

The 33 plans' unfunded benefits increased significantly during the 5-year period. The plans' assets did not cover 44 percent of their vested benefits at the start of the period. At termination, the plans were 66 percent unfunded. During the 5 years, unfunded benefits almost doubled, to \$450 million.

We identified several factors contributing to the increased underfunding during the 5 years before termination. Although we were not able to quantify the dollar effect of all of the factors, we believe that each contributed significantly to the underfunding of the 33 plans. Specifically, we found that

- 9 employers received business hardship funding waivers for contributions totaling \$29 million that were unpaid at termination,
- 12 employers did not make \$41 million in required contributions that had not been waived before termination,
- 20 employers had \$57 million in current contributions that became due when they terminated their plans,
- 18 employers increased 27 plans' benefits which were generally guaranteed by the insurance program and unfunded at termination (benefits increased in 16 plans three or more times and benefit increases in 17 plans became effective while contributions were waived or unpaid), and
- Most contributions made to the plans before termination did not exceed the minimum required levels.

POTENTIAL EFFECTS OF THE 1986 AMENDMENTS

The 1986 amendments were primarily designed to strengthen the insurance program's financial viability by increasing program revenues and helping to control claims or increase collections from employers terminating underfunded plans. These provisions include (1) raising the annual premium from \$2.60 to \$8.50 per plan participant, (2) requiring employers to meet prescribed standards of financial distress in order to terminate plans, (3) increasing the employer liability for terminated plans' unfunded benefits, and (4) allowing IRS, when needed, to require that employers provide security for funding waivers of \$2 million or more.

These amendments should help avoid claims from some underfunded plans and better finance claims that do occur. For example, the higher premium rate will raise program revenues by an estimated \$180 million this year. Also, the distressed employer termination provisions should help the program avoid claims from employers not distressed. Further,

collections of waived contributions after termination should be improved to the extent that IRS requires security.

However, it is too early to tell whether the amendments will ensure the long-term viability of the insurance program. Our review indicates that about half of the \$500 million in program claims during the 1983-85 period came from underfunded plans of 17 employers who were in bankruptcy proceedings at plan termination. Considering this, the Corporation's ability to sufficiently improve its recovery of claims from distressed employers is doubtful, even with the increased employer liability.

Recent large claims now raise serious doubt about the ability of the \$8.50 premium to cover future claims and pay off the program's deficit. An \$8.50 rate will retire the newly estimated deficit of \$1.3 billion within 15 years if future claims average \$100 million a year. However, the Corporation now forecasts future claims to average between \$220 million and \$450 million a year. Based on these forecasts, the Corporation estimates that the program's deficit could grow to between \$1.5 billion and \$2.5 billion within 5 years without another premium increase. We believe these forecasts are reasonable, given our past analyses of premium needs and the program's recent claims experience.

ALTERNATIVES FOR CONTROLLING PLAN UNDERFUNDING AND ITS EFFECTS

Some plans are significantly underfunded. Current law may not be adequate to protect the insurance program from potential large claims should these plans terminate. Therefore, further changes should be considered to protect the program's viability. Such changes could include modifying current law to

- require more rapid payment of unfunded benefits, especially those resulting from benefit increases,
- require employers to make minimum contribution payments to their underfunded plans sooner than 8-1/2 months after the end of the plan year,
- further limit the guarantee of benefit increases, and
- raise the premium rate to provide the revenue needed to retire the program's deficit and pay for estimated future claims.

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This concludes my testimony. We will be happy to answer any questions at this time.

TESTIMONY OF
DR. KATHLEEN P. UTGOFF
EXECUTIVE DIRECTOR
PENSION BENEFIT GUARANTY CORPORATION
BEFORE THE
SUBCOMMITTEES ON OVERSIGHT AND SOCIAL SECURITY
COMMITTEE ON WAYS AND MEANS

June 24, 1986

Messrs. Chairmen:

Thank you for this opportunity to present the views of the Pension Benefit Guaranty Corporation on the underfunding of private pension plans. This subject is of vital concern to the PBGC, because we - that is, the 110,000 pension plans that pay premiums to our single-employer insurance program and the companies that sponsor them - ultimately must absorb most of the cost of inadequately funded pension promises. Much of the remaining cost falls on pension plan participants, who frequently suffer benefit cutbacks when an underfunded plan terminates.

The cost of underfunded pension plans has turned out to be much greater than anyone expected when the PBGC was established in 1974. At that time, Congress envisioned a small, inexpensive program that would protect workers in those relatively rare instances where pension plans terminated without sufficient funds to pay promised benefits. A Department of Labor study, based on plan terminations in 1972, concluded that such a program would incur about \$25 million in net claims each year, an amount that could be covered by the initial PBGC premium of one dollar per insured plan participant.

Experience quickly diverged from expectations. Almost from its first day, the PBGC operated at a deficit. Congress raised the premium to \$2.60 per participant, starting in 1978. This amount also proved inadequate. In 1982 the PBGC was forced to request another premium increase. Accompanying the request were proposed reforms designed to correct weaknesses in the operation of the insurance program. The Single-Employer Pension Plan Amendments Act of 1986, which was signed into law, on April 7, 1986, included a premium of \$8.50 per participant and more limited reforms than the Administration had asked for.

Unfortunately, an \$8.50 premium and the attenuated reforms that went along with it will not cure the PBGC's financial woes. We now estimate that, as of the end of 1985, a premium of \$13.50 per participant would have been needed to cover future claims and retire the PBGC's \$1.3 billion deficit. The same projections indicate that, with an \$8.50 premium, our deficit will grow at a rate of \$100 million per year.

Why has the modest and beneficent program that Congress approved in 1974 become so much larger and more costly than anyone anticipated? The primary reason is that the plans that now come to the PBGC for help are larger than ever before and less well-funded.

During fiscal years 1975 through 1978, the average plan trusted by the PBGC was 55 percent funded for guaranteed benefits. That ratio dropped to 47 percent during the period 1979 through 1982 and to 38 percent for 1983 through 1985. While funded ratios were declining, the average amounts of underfunding increased dramatically, from \$300,000 per plan in 1975 through 1978 to \$1 million in 1979 through 1982 to \$3.5 million in 1983 through 1985.

At first glance, this trend is a surprise, for pension plans in general have become better funded over the years. Among all terminating plans, the percentage that are fully funded for accrued benefits has roughly doubled over the past three years, and it has been estimated that defined benefit pension plans as a whole have assets about \$200 billion greater than the present value of their liabilities. Evidently, the rules that currently govern pension funding have led to increased disparities between well-funded and poorly funded plans.

The incentives that give rise to this divergent behavior stem from the structure of the present PBGC insurance program and from waivers of the minimum funding standards being granted without a security interest for the plan. Compounding the problem is the fact that the funding standards themselves are not designed to ensure that plans become fully funded on termination. I should like to address each of these points in turn.

The PBGC's Present Structure

Under current law, the PBGC must charge the same premium per participant to all covered plans, regardless of the size of a particular plan's unfunded liabilities or the probability that it will give rise to a claim against the insurance program. Furthermore, although the PBGC can, in theory, recover its insurance losses from plan sponsors, our claims have only unsecured creditor status in bankruptcy and thus are worth only about seven to 15 cents on the dollar.

The conjunction of non-risk-related premiums with the PBGC's weak standing in bankruptcy means that companies that are experiencing business difficulties have little incentive to fund their pension plans. An obvious strategy for both employers and employees is to cut back funding, use the savings for other purposes and let the PBGC pick up the tab if the plan terminates. Under present law, this is both rational and legal.

The termination of Wheeling-Pittsburgh's pension plans showed just how profitable underfunding can be. By terminating its plans, Wheeling-Pitt saved over \$3.00 per hour in pension costs, a subsidy that will be borne by companies that maintain defined benefit plans. Wheeling-Pitt's competitors in the steel industry will have competition from a company that has been granted a significant labor cost advantage and will also have to bear the cost of higher PBGC premiums. Of course, other steel companies with underfunded plans can follow in Wheeling-Pittsburgh's footsteps, subject to SEPPAA's new liability requirements, but one may reasonably ask whether these crisscrossing subsidies do the steel industry or the economy any good. Certainly, they do not lead to a sound pension insurance program.

Thus the current structure of the PBGC's program encourages troubled companies to underfund their pension plans. At the same time, such tactics are abetted by some of the legal rules that govern plan funding. Both ERISA's minimum funding standards and the provisions of law setting conditions for waiving the minimum funding requirements contribute to the PBGC's plight.

Minimum Funding Standards

The declared purpose of ERISA's minimum funding standards is to require companies that make pension promises to put aside sufficient funds to make good on those promises. The actual statutory rules, however, achieve this purpose only indirectly - and in some instances do not achieve it at all.

The history of the Allis-Chalmers UAW Pension Plan, which terminated on July 26, 1985, with virtually no assets on hand, strikingly illustrates the inability of ERISA's minimum funding standards to assure adequate funding - or even mere solvency - in all cases. At termination, the present value of the Allis-Chalmers plan's liabilities exceeded the value of its assets by \$170 million. The termination resulted in the the second largest claim in the PBGC's history.

During the existence of the Allis-Chalmers plan, the sponsor requested no minimum funding waivers for the plan. The plan actuary utilized a "middle of the road" actuarial method (frozen initial liability) and assumptions (e. g., 7 percent investment return) throughout the period during which the minimum funding standards were in effect.

The plan's problems can be traced to the fact that the minimum funding standards permit "unfunded past service liability" to be amortized over relatively long periods, even where the plan is top-heavy with retirees. On January 1, 1977, the Allis-Chalmers plan had 4,700 active participants and 6,500 retired and separated vested participants. The active lives decreased steadily over the next few years. At the time of termination, they constituted only 15 percent of the participant population (1,300 actives out of 8,500 total). Due to the large proportion of retirees, the plan's minimum funding requirement was, from 1977 on, always less than its annual benefit payments.

The depletion of the plan's assets was slowed somewhat by an agreement between the plan sponsor and the union that contributions would be made in excess of minimum funding requirements (though even these additional amounts did not result in contributions in excess of benefit payments). In 1982 the union agreed to allow contributions to revert to the ERISA minimum. Because of the "excess" contributed in earlier years, the plan's funding standard account had a substantial positive credit at this point; the minimum funding requirement for 1982 was zero.

From 1982 on, the plan's assets dwindled rapidly. When it terminated in July 1985, funds on hand were sufficient for only two months of benefit payments. Clearly, ERISA's minimum funding standards failed to achieve their purposes in this case.

In the PBGC's view, the minimum funding standards need to be reexamined with the goal of preventing grossly inadequate funding, without imposing extra costs on sponsors of well-funded plans. Some possible approaches for consideration are:

1. Special minimum funding standards could be established for plans that failed to meet specified financial criteria. For example, sponsors could be required to fund unfunded vested benefits over specified periods, with a shorter funding period required for benefits in pay status than for other benefits.
2. Sponsors of underfunded plans could be required to make contributions at least equal to annual benefit payments or to the amount needed to prevent the unfunded vested benefit liability from increasing.
3. ERISA's definition of "reasonable funding method" could be amended to require that the method chosen assure plan solvency over some reasonable future period of time, based on realistic projections employing a variety of scenarios for future interest rates and employment patterns.

Minimum Funding Waivers

Even where the minimum funding standards would normally function adequately, they can be waived for companies in distress. Many of the largest claims against the PBGC have come from plans that received funding waivers during the last few years before termination. Wheeling-Pittsburgh, for example, was granted funding waivers for 1982 and 1983 and also made no contributions for its 1984 and 1985 plan years.

The PBGC reform package that was proposed by the Administration required all minimum funding waivers above a de minimis level to be secured by a lien on the plan sponsor's assets, unless the Internal Revenue Service and the PBGC agreed to waive security or accept alternative collateral.

A minimum funding waiver has the same economic effect as a loan from the plan to the plan sponsor. If a plan that receives a waiver is underfunded and on the brink of termination, the real lenders are the firms that pay premiums to the PBGC. The Administration believed that, since it was the PBGC premium payers' money that was on the line, we should have some say in setting the terms on which we extended credit. We would not, of course, have been precluded from making the sort of rational accommodations that any lender to a troubled company must consider. Each case has to be evaluated on its own merits, a task that is best performed by those who have a financial stake in the outcome.

SEPPAA's provisions relating to minimum funding waivers did not include the security protections that the Administration had requested but only much more limited changes. On the plus side, the I.R.S. has made every effort to keep the PBGC apprised of significant minimum funding waiver requests and has arranged in two recent cases for adequate security for funding waivers. These developments are very encouraging.

In summary, I should like to emphasize the following points:

First, despite the general improvement in pension plan funding since 1974, the funded status of those plans that take advantage of PBGC benefit guarantees has deteriorated, placing greater pressure on an already overburdened insurance program.

Second, the structure of the current PBGC insurance program, under which good and bad risks are charged identical rates and PBGC claims against employers have low priority in bankruptcy, encourages the riskiest plans to forgo sound funding.

Third, minimum funding waivers should not be used as a source of financing at the expense of plan participants and the PBGC's premium payers.

Fourth, the minimum funding standards do not adequately protect the PBGC or plan participants in a number of cases. In the PBGC's view, the funding standards need to be reexamined.

I will be happy to answer any questions that you may have.

Statement
by
Dallas L. Salisbury
Frank B. McArdle
Man-Bing Sze
Submitted to the
U.S. House of Representatives
Joint Hearing on Pension Plan Underfunding
Committee on Ways and Means
Subcommittees on Oversight and Social Security

June 24, 1986

Dallas L. Salisbury is president of the Employee Benefit Research Institute, Frank B. McArdle is director of education and communications and Man-Bing Sze is research associate. The views expressed in this statement are solely those of the authors, and do not necessarily represent the views of the trustees and sponsors of the Employee Benefit Research Institute, or its staff.

Chairman Pickle and Chairman Jones, we wish to commend you for your continued pursuit of the policy issues surrounding the nation's retirement income system, and we are honored to provide the committee with our analysis of the funding issues associated with private pension plans in the United States.

In particular, we are restricting our remarks to the question of underfunding of pension plans. In keeping with EBRI's standard policy, we will not be making recommendations or advocating any particular policy position. Rather, we will strive to provide the Committee with an analytical framework for making its own evaluation of this important question.

Is Underfunding of Private Pensions a Serious Problem?

Whether you believe the private pension system is underfunded or not will depend to a very large extent on the manner in which you choose to view the liabilities associated with pension plans. Overall, the private pension system has accumulated well over \$1 trillion in assets that stand behind the claims to benefits made by active participants and beneficiaries. This constitutes the largest single funding source of pensions in the world, and adds considerable security to the benefit promise under private plans.

Mechanics of Funding

How does ERISA allow underfunding to occur? As you know, ERISA established rules for minimum and maximum funding standards for defined benefit plans, requiring employers to satisfy the minimum required plan contribution each year.

Minimum-Funding Standards -- For accounting purposes, pension costs are divided into two parts: normal costs and supplemental costs. Normal costs for a year are simply the amount of benefit liability accrued that year due to normal plan operation, calculated using that year's actuarial assumptions. Supplemental costs are those associated with supplemental liabilities, which include liabilities associated with changes in actuarial assumptions, liabilities arising because experience varies from actuarial expectations, liabilities resulting from retroactive benefit increases, and liabilities associated with the funding of service credit prior to plan establishment (if such credit is given).

Although many different actuarial methods of funding normal costs are permitted, each implying a somewhat different contribution schedule, employers are generally required to contribute at least the normal cost each year.

The employer must also contribute to supplemental costs. The amount of these contributions is determined by amortizing supplemental liabilities over specified periods. Gains or losses arising from differences between actuarial expectations and actual experience (calculated no more frequently than once every three years) may be amortized over 15 years; other supplemental liabilities may be amortized over 30 years, or 40 years if incurred before ERISA's passage in 1974.

If the employer does not satisfy the necessary contribution because he would incur substantial business hardship, and if enforcement of the minimum funding requirements would be adverse to the interests of plan participants in the aggregate, the employer may seek a funding waiver from the Internal Revenue Service for all or part of the minimum funding requirements. Waivers cannot be granted more than 5 out of any consecutive 15 years. If the waiver is granted, amounts waived may be amortized over 15 years. Without an approved waiver, employers not meeting the minimum contribution standard are subject to a tax on the unpaid amount.

The Pension Benefit Guaranty Corporation (PBGC) has no formal role in the waiver process. Prior to passage of recent PBGC reforms, PBGC Executive Director Kathleen Utgoff attributed 20% of the PBGC's deficit to waivers granted in just 22 large termination cases. Corrective measures are now being taken. The Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) permits the IRS to require "security" as a condition of granting waivers or extensions in excess of \$2 million. Furthermore the IRS must now notify PBGC

of waiver applications in excess of \$2 million, and employers applying for waivers must notify employee organizations. IRS must consider written opinions of all parties interested in a waiver applications. Despite the new law, the PBGC is still left at risk by the waiver process.

In practice, pension funding rules allow considerable flexibility, in part to accommodate the very diverse situations of the employers sponsoring plans. The actual amount of an employer's contributions will depend upon the actuarial cost method it chooses to use and, in certain circumstances, the funding instrument employed. Even the minimum and maximum constraints are generally expressed in terms of the actuarial cost method used by the employer. Any of several actuarial methods may be selected if the actuary certifies that the method and the assumptions are reasonable in the aggregate. ERISA lists six acceptable actuarial methods. Since funding is tied to the actuarial cost method used, funding and actuarial methods are closely interrelated.

For example, because an employer who maintains a qualified defined benefit pension plan is required to fund the cost of projected benefits on a level basis, it is necessary to make certain assumptions with respect to the level of benefits that actually will be provided by the plan. These involve economic conditions and future events. These assumptions, in particular, the assumption of future interest rates, can have a significant effect on estimates of the cost of a plan and on deduction limits with respect to employer contributions to plans.

But the adequacy of that funding can be measured in two ways: (1) against the liabilities present if the plan were to be terminated and (2) against the additional liabilities that will accumulate if the plan is maintained on an ongoing basis.

Termination-Basis Funding

A plan that holds sufficient assets to provide for the payment of all accrued benefits (through the purchase of annuities) is said to be sufficiently funded "on a termination basis." Hence, the termination-basis sufficient funding level of a plan is simply the present value of all accrued benefits. A plan that holds assets in excess of that level is said to be "overfunded" on a termination basis. If such an overfunded plan is terminated, the excess assets can be recovered by the employer. The recent controversy surrounding the number of plans terminating to recapture excess assets suggests that many pension plans are overfunded.

Termination basis measurement is appropriate to, and reflective of, the legal obligations of an employer sponsoring a pension. As you well know, the decision to sponsor a pension plan in the United States is a totally voluntary one on the part of the employer. Legally, employers have no obligations to continue the pension plans. In practice, terminations of pension plans happen infrequently. Whether a pension plan is treated as terminating or continuing makes a difference in the amount of the pension liabilities, because the benefit formula usually includes wage and service factors.

Accrued liability is a legal interpretation of corporate responsibility in which the firm assumes no legal obligation to continue the pension plan. One justification for this is that the accrual of additional benefit is contingent upon the worker rendering future services. ERISA considers termination of pension plans a business decision. Because of the option of plan termination, the accrued cost method emphasizes increments in accrued benefit in the current year.

The present value of accrued benefits (or the cost of annuities to pay them) depends on the benefit formula(s) of the plan and two actuarial factors: the expected future rate of return and the life expectancy of beneficiaries.

When a pension plan is terminated, the sponsor knows exactly the amount of liability because it has to negotiate with insurance companies to buy annuities. But few plans are terminated each year. When these nonterminating plans use termination-basis accounting, one has to make interest rate (discount rate) assumptions. Market interest rates change from year to year. Therefore, an interest rate used in one year may not be appropriate for the next year. Consequently, overfunding in one year could become underfunding in

the next. For this reason most plans use an interest rate representative of long term expectations rather than current year returns. This approach "smooths" the flow of contributions and is generally termed "conservative." Some plans, however, shift from this practice when difficult economic conditions face them.

Notwithstanding the effect of interest rate assumptions, available data indicate that, on average, termination-basis funding levels of pension plans have risen over the last several years. Our analysis of various surveys conducted by the Wyatt Company, Johnson and Higgins, Greenwich Associates, and BEA Associates all points to the rising level of pension funding measured on a termination basis. (See EBRI Issue Brief #54, pp. 8-9 for details.) Charts 1 and 2, based on Wyatt's 1985 Survey of Actuarial Assumptions and Funding, illustrates the steadily increasing percentage of plans (78 percent in 1985) that are sufficiently funded on a termination basis for total accrued benefits.

As far as the magnitude of the unfunded liabilities measured on a termination basis, EBRI's tabulations from Greenwich Associates data indicate that in 1985, 1,500 of the largest corporate single-employer pension plans, when viewed as a group, had total accrued pension plan liability of \$456.9 billion against total assets of \$430.5 billion, or total unfunded accrued liability of \$23.4 billion in 1985. This represents a substantial improvement over the year 1978, when total accrued liability of \$247.7 billion measured against total assets of \$172.4 billion, for a total unfunded accrued liability of \$75.3 billion. The ratio of assets to accrued liability improved from a 70% ratio in 1978 to a 95% ratio in 1985.

If we look at pension liabilities of only the plans with underfunding, we find that in 1984, based on the Johnson and Higgins latest Executive Report on Large Corporate Plans, 66 plans in the sample of 453 large plans had total unfunded accrued liability on a termination basis of about \$10 billion.

It must be emphasized that it is important to distinguish between termination-basis funding sufficiency and a more general concept of appropriate funding in an ongoing pension plan. Termination-basis sufficiency is mainly pertinent to actual plan termination under current law.

Ongoing Funding

Funding in an ongoing plan is based on the explicit assumption that the firm will continue the pension plan far into the future and is therefore geared to anticipating expected future liabilities.

These liabilities, like those of a terminated plan, are determined by plan provisions and actuarial factors. But whereas termination liabilities depend on only two actuarial factors, measuring ongoing future liabilities is far more complex and depends on many factors, such as:

- o expected future rate of return on plan assets;
- o life expectancy of beneficiaries;
- o work force characteristics, present and future--including number of employees, age distribution, and rate of turnover;
- o retirement ages;
- o wage and salary growth; and
- o the prospects of business continuation.

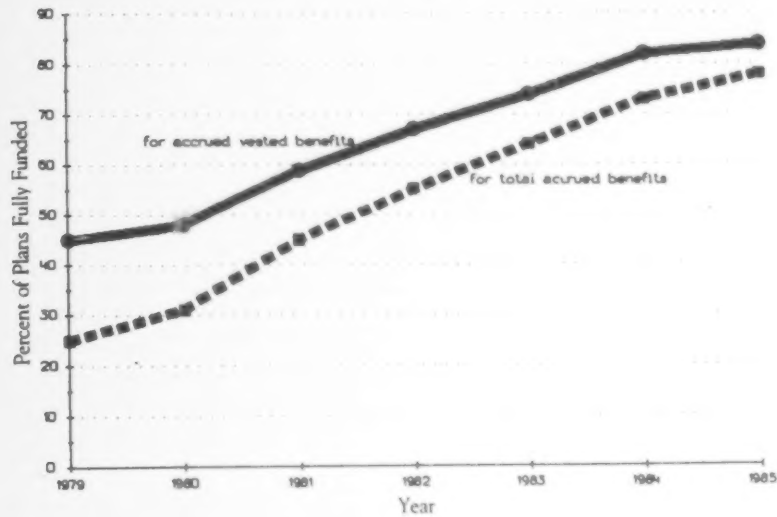
Both termination liability and ongoing future liability are affected by benefit formulas; ongoing future liability is also affected by vesting standards, retirement age provisions, and other plan provisions.

Once actuarial estimates of ongoing liability have been made, a contribution schedule must be chosen by which ongoing liabilities can be funded. A contribution schedule allows a plan sponsor to spread pension costs more evenly over the work-life of the participant for whom benefits are accruing.

Unfortunately, no plan sponsor data for the universe of private defined pension plans is currently available on ongoing pension liabilities, although in the next several years, some data will begin to emerge as a result of the new rules published by the Financial Accounting Standards Board (FASB), which will require sponsors to provide information on ongoing pension liabilities.

Chart 1

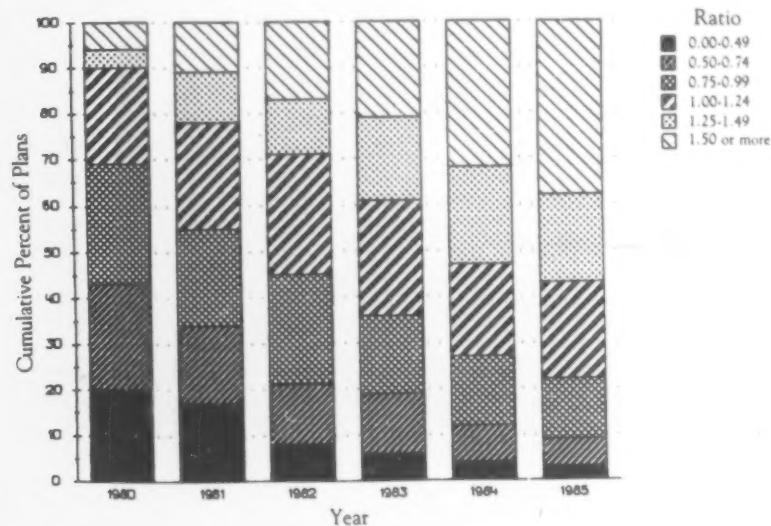
Defined Benefit Pension Plans with 1,000 or More Participants: Percent Fully Funded for Accrued Vested Benefits and Total Accrued Benefits



Source: The Wyatt Company, 1985 Survey of Actuarial Assumptions and Funding. Sample of 948 plans.

Chart 2

Defined Benefit Pensions Plans with 1,000 or More Participants: Percent Distribution by Ratio of Assets to Total Accrued Benefit Liabilities



Source: The Wyatt Company, 1985 Survey of Actuarial Assumptions and Funding. Sample of 948 plans.

Nevertheless, in most cases, ongoing liability will likely exceed termination-basis liability. Consequently, ongoing liability is more likely to be less than fully funded. This fact does not necessarily suggest that the pension system is in danger or that pension funding is weak. Additional employer contributions and additional investment returns will have accrued before all of the ongoing obligations fall due.

Measuring Funding Adequacy

To restate, in somewhat different terms, the differences between these two approaches to measuring funding adequacy it might be helpful to use a stock-and-flow concept. In a simplified way, termination funding is the stock of assets on hand. The question then is: Does the plan have enough assets to buy annuities to satisfy the accrued liabilities to date?

Ongoing funding adequacy refers to both the stock of assets already in the fund and the flow, or expected, annual contributions the plan sponsor is required to make to meet the present and future liabilities. Are the assets sufficient to buy annuities to satisfy all future liabilities? Generally, the answer is "no." Nor does the law require it. Funding adequacy then depends on whether the flow of annual contributions plus investment returns will be sufficient. This is a very difficult question to answer. Few researchers have examined it. Companies can and do alter their contributions and variations in key actuarial assumptions can produce dramatic differences in results. Table 1 shows the adjustment made to ongoing pension liabilities by using a different interest rate. For example, using a 7% interest rate instead of an 8% interest rate can increase liabilities by 21%.

Table 1
PENSION PLAN LIABILITY ADJUSTMENT FACTOR

Reported Interest Rates	Liability Adjustment Factor Under Alternative Interest Rates							
	0%	2%	4%	6%	8%	10%	12%	15%
0%	1.00	0.58	0.35	0.23	0.19	0.11	0.03	0.05
1%	1.22	0.77	0.47	0.30	0.20	0.14	0.11	0.03
2%	1.77	1.00	0.61	0.39	0.25	0.19	0.14	0.11
3%	2.22	1.23	0.75	0.50	0.34	0.24	0.19	0.14
4%	2.93	1.64	1.00	0.64	0.40	0.31	0.22	0.17
5%	3.95	2.06	1.25	0.81	0.44	0.34	0.23	0.22
6%	4.41	2.55	1.55	1.00	0.68	0.48	0.25	0.27
7%	5.42	3.12	1.91	1.22	0.83	0.63	0.43	0.33
8%	5.53	3.75	2.32	1.43	1.20	0.71	0.52	0.40
9%	7.93	4.50	2.75	1.77	1.20	0.85	0.62	0.48
10%	9.24	5.34	3.05	2.09	1.41	1.00	0.74	0.57
11%	10.55	6.24	3.31	2.44	1.65	1.17	0.85	0.55
12%	12.46	7.20	4.40	2.83	1.91	1.35	1.00	0.77
13%	14.31	8.29	5.05	3.24	2.19	1.55	1.15	0.93
14%	16.27	9.42	5.74	3.69	2.49	1.75	1.30	1.00
15%	19.25	10.62	5.48	4.15	2.81	1.99	1.47	1.13

Source: Man-Bing Sze, Pension Funding Policy and Corporate Finance (Santa Monica, The Rand Corporation, R-7144-R61, 1969), p. 43.

Actuarial Assumptions and Funding

Government and private regulatory bodies continue to take note of the importance of actuarial assumptions. Recent legislative actions -- the requirement in H.R. 3838 that key actuarial assumptions be reasonable standing alone, rather than in the aggregate (current law) -- and the new FASB rules may result in more uniform interest rates across plans in valuing pension liabilities. These changes may, however, lead to large annual assumption changes rather than "smoothing," and could actually make interpretation of the true funded status of the pension system more difficult. The results of significant changes in investment returns, for example, is shown by the pattern of declining annual contributions. This is largely due to rising investment returns and increasing actuarial assumptions. Data from Greenwich Associates (table 2) shows that aggregate contribution levels for large plans have fallen each year since 1982. From 1984 to 1985 alone, the decrease was 13 percent.

Table 2

Percent Change in Aggregate
Contributions from Preceding Year
in Large Single-Employer Plans*

Year	Change
1983	-15%
1984	- 2
1985	-13

Source: EBRI tabulations based on Greenwich Associates, Report to Participants on Large Corporate Pensions, 1979-1986.

*Estimates of aggregate pension finding in 1,500 of the largest corporate plans, based on a sample of approximately 1,000 plans.

A future concern: What will happen if the stock market reverses itself, investment returns decline overall, and lower interest rate assumptions seem more realistic for valuing returns long term? For some plans that have used high actuarial assumptions, this could result in a deterioration of funding adequacy on an ongoing basis and much higher contributions required of employers at a time when the overall level of economic activity, as measured by the stock market performance, may not be at its best. Recent actions (H.R. 3838 and FASB) may work together to push investment return assumptions up and to increase funding volatility. As a result, most plan sponsors have criticized these changes.

Economic Causes of Underfunding

We realize that the Committee has before it recent examples of large firms that have terminated their pension plans with insufficient funds to pay accrued liabilities. Without dwelling on any single firm, we would like to advance some explanations about why certain companies may underfund their pension plans.

Ironically, a valued part of ERISA, the creation of the guaranty program administered by the Pension Benefit Guaranty Corporation, creates an incentive for some employers to underfund their pension plans, knowing that any unfunded liabilities can be shifted to PBGC upon plan termination. As stated in the 1986 Economic Report of the President: "With the establishment of the PBGC, a company can make generous retirement benefit promises to employees, and pay employees lower wages than it otherwise would, because both parties know that if the company fails, the PBGC will honor the pension obligations (up to ERISA-limited amounts)."

The president's Economic Report goes on to explain, "The companies most likely to abuse PBGC pension insurance are those doing poorly. Companies losing money enjoy no tax benefits from fully funding pension plans and are also less likely to be able to deliver on pension promises with company assets." Other studies confirm that companies in financial difficulty are the most likely ones to underfund a pension plan and shift risk to the PBGC. But the relationship of pension funding to corporate profitability and tax liability underscores another potential economic reason for underfunding -- or overfunding -- namely the concerns of corporate finance.

Companies can control the flow of money into pension funds because of the flexibility ERISA allows in amortizing plan liabilities. Many plans continue giving benefit increases after plan funding has begun to deteriorate and, under ERISA, can fund these increases over 30 years--for a declining industry, a very long time period. Yet, this flexibility is one of the primary reasons public and private employers have been willing to sponsor defined benefit pension plans. By synchronizing the timing and amount of pension contributions, funding strategy becomes a valuable tool in financial planning. Corporate and joint-trust use of pension funding for such purposes falls within the current funding rules, and coexists along with ERISA's fiduciary rule that pension funds must be managed for the exclusive benefit of participants. The implications of new pension accounting rules published by the Financial Accounting Standards Board now make more clear what many have known for years: that pension funds may constitute a large and growing corporate asset.

Declining employment in certain industries may also lead to underfunding, since the declining ratio of participants to beneficiaries increases the employer's pension costs, particularly if the plan has not been fully funded up to that point.

Impact of Pension Underfunding on PBGC

Underfunding, itself, does not exert an immediate adverse effect on the PBGC -- although it always poses a potential risk to PBGC because the plan sponsor has had the option to terminate the plan at will. Obviously, the termination of an underfunded plan does pose financial burdens on the PBGC and eventually requires additional premium payments by nonterminating employers to finance the underfunded terminations. COBRA, in addition to the premium increase, modifies the termination rules, making it more difficult for an employer to terminate an underfunded plan and reduces PBGC's exposure somewhat. But even under the new law, PBGC has limited claims in an underfunded situation. Recently, the current executive director of the PBGC has suggested additional steps that may be needed: (1) a \$13.50 premium per participant; (2) changes in bankruptcy laws to give PBGC a higher priority as creditor in bankruptcy proceedings; and (3) tighter minimum funding standards.

In addition to the financial impact on the PBGC, one must also consider the adverse effects underfunded plans have on the way the insurance program is viewed by the private sector. To the extent that underfunded terminations continue and force escalating PBGC premium increases, another negative reason exists for not establishing or maintaining a defined benefit plan. To the extent that premium increases continue to rise -- and they will have to in the future, despite the new law -- it aggravates the inequity of asking responsible employers to pay for PBGC's \$1.5 billion deficit. Such inequities might eventually dispose even strong plan sponsors to terminate their plans, rather than continuing to subsidize weaker firms. And if that happens, the financial burden on the employers remaining in the PBGC will worsen in a vicious cycle.

All of these effects can be viewed as negative influences underfunded plans exert on the private sector pension system as well as on PBGC.

Impact on Federal Treasury

Since the agency that guarantees pension benefits is financed by employer-paid premiums, the termination of an underfunded pension plan has no adverse effect on the federal treasury. In the short run, underfunding can actually increase federal revenues because -- all things being equal -- an underfunded plan means less tax deferral.

In the long run, however, the federal treasury could well become involved if PBGC's deficit should worsen and if the appropriate premium increase were neither politically feasible nor desirable. In that sense, it is not inconceivable that general revenues could be tapped to help finance PBGC, just as they have been tapped for Social Security, Railroad Retirement, Civil Service Retirement, and others.

Impact of Underfunding on Pensioners and Active Participants

Generally, ERISA requires PBGC to insure "basic" vested benefits up to a maximum. PBGC is also authorized to insure nonbasic benefits but has not opted to do so.

Under PBGC regulations, basic benefits include any vested retirement benefits including cost-of-living adjustments effective prior to termination and any death, disability or survivor benefit that was owed or in payment status at the date of plan termination.

Despite the guaranty program, both beneficiaries and active participants run the risk of losing some benefits in the event an underfunded plan terminates.

Beneficiaries in current payment status may suffer a reduction in their payments after an underfunded termination for two reasons: PBGC only insures up to a maximum indexed dollar amount (\$1,789.77 monthly in 1986) and (2) benefits promised by plans or plan amendments in effect for less than five years at termination are not fully insured.

In underfunded terminations, active participants may also lose some accrued benefits. PBGC guarantees payment of basic benefits up to an indexed maximum. Under the new law, in addition to liabilities guaranteed by PBGC, the terminating employer is also, within prescribed limits, liable to plan participants for vested benefits not insured by PBGC. However, such a claim may be difficult to enforce on financially ailing firms. Moreover, for firms that can afford to pay, once legislated limits are reached, noninsured vested benefits that are still unfunded are lost.

In addition, participants in underfunded plans that terminate lose accrued benefits that are not vested prior to termination. (In contrast, in a sufficient termination all accrued benefits vest upon termination and must be paid.) In 1984, 85 percent of defined benefit pension plans used "10-year cliff vesting" schedules. If an underfunded termination occurs before the worker's tenth year of service, no benefits will be paid to the worker and earned benefits will be lost. If the House of Representatives accepts the Senate provision in H.R. 3838 for five-year vesting under private plans, fewer workers will lose all their benefits in an underfunded termination. But the same principle will still apply, i.e., workers whose service has not vested will not receive any benefits after an underfunded termination.

Conclusion

Congress imposed funding standards upon employers to improve the security of the pension benefit promise.

Overall, the standards adopted by Congress have achieved that goal. In general, private plans are far better funded than they were before ERISA, and current measures of funding on a termination basis have been improving over the past several years. Combined with the insurance provisions of ERISA, pensions are far more secure in the vast majority of cases.

Despite the generally favorable picture, the current rules still allow a minority of individual firms to underfund their plans. Basically, this is because ERISA allows considerable flexibility in choosing the period for amortizing funding of plan liabilities which is, in turn, closely related to funding levels. Funding waivers available to firms experiencing substantial business hardship also allow plans to underfund.

Termination of underfunded pension plans contributes to the PBGC's financial deficit, further aggravates inequities within the single-employer insurance program between financially weak sponsors and the financially strong sponsors

who subsidize them through the PBGC premium, and exposes both beneficiaries and participants to potential benefit losses.

Recent legislation will make it more difficult for plans to terminate and raises substantial revenue for PBGC. But it doesn't cure the problem of underfunded pension plans, and another round of premium increases and further reforms may be expected.

The pending tax reform bill would make changes in the rules governing actuarial assumptions. Five-year vesting, if adopted by the House, will cut down on some of the accrued benefit losses experienced by active participants in terminating underfunded pension plans. Other recent developments warrant continued attention of Congress, such as the reaction of corporate pension funding behavior to the recently announced FASE rules for pension accounting, and the recent decline in corporate contributions to pension plans in the wake of unusually large investment gains. In particular, Congress should be aware that pension funds are a large and growing corporate financial asset, and changes in pension legislation can have a large effect on employers' willingness to fund pensions.

STATEMENT TO
THE SUBCOMMITTEES ON OVERSIGHT AND SOCIAL SECURITY
OF THE
HOUSE COMMITTEE ON WAYS AND MEANS
BY NORMAN S. LOSK
PENSION COMMITTEE
OF THE AMERICAN ACADEMY OF ACTUARIES

HEARING ON NATIONAL RETIREMENT
INCOME POLICY: UNDERFUNDED PENSION PLANS

JUNE 24, 1986

The Pension Committee of the Academy of Actuaries appreciates the opportunity to provide testimony to the Subcommittees on Oversight and Social Security of the House Committee on Ways and Means. Funding of private pension plans is a substantial area of interest and an area of competence of the actuarial profession. It is in this spirit that we offer the following comments.

Background

The American Academy of Actuaries is a professional association of over 8,000 actuaries involved in all areas of specialization within the actuarial profession. Included within our membership are approximately 86% of the enrolled actuaries certified under the Employee Retirement Income Security Act of 1974 (ERISA), as well as comparable percentages of actuaries providing actuarial services for other employee benefit plans such as life, health, and disability plans. As a national organization of actuaries, the Academy is unique in that it includes actuaries with expertise in all areas of actuarial specialization. With respect to government relations, the Academy views its role as a provider of information and actuarial analysis in order that policy decisions may be made with informed judgement. It is our belief that the training and experience of Academy members allows for unique understanding of current practices in employee benefits. It is our intention to communicate that understanding in ways that assist public policy makers. We are grateful for the invitation to appear here today and look forward to working closely with the members and staff of the subcommittees on all issues relating to national retirement policy.

Funding Retirement Plans

In order to provide perspective, we would like first to discuss the elements of pension funding. The funding concepts relative to defined benefit pension plans are often misunderstood. While the members of the committee and their staffs have worked at developing an understanding of these concepts, we feel that it would be helpful to provide these introductory remarks.

A defined benefit pension plan is nothing more nor less than a set of promises. In a single employer retirement plan, for example, the employer in that plan agrees to provide benefits, calculated in accordance with a specific and well-defined formula, to its employees who may retire voluntarily, become disabled, die, etc.

Thus, the primary obligation of the plan sponsor is not to make contributions to the plan or to invest the funds of the plan. The primary obligation of the plan sponsor is to provide the benefits promised in the plan.

In order to properly budget for the benefits to be provided, to provide a level of security for the participants in the plan, to satisfy the requirements of the federal minimum funding requirements, and ultimately, to accumulate assets in an orderly way to provide the benefits of the plan, the plan sponsor provides funding for the plan by making contributions. The plan sponsor relies on an actuary to determine a range of appropriate contributions that can be paid into the plan each year.

At any point in time, there is no way to know with precision the magnitude of the financial commitment made by the plan sponsor. The job of the actuary is essentially to make statistical projections of the benefits expected to be paid from the retirement plan. In this sense, an actuarial valuation is similar in nature to long-term projections of benefit outlays under Social Security, or even to short- and medium-term projections of such items as federal revenues, expenditure levels, and so on.

In order to make such projections the actuary simulates, statistically, all the dynamics inherent in retirement plans. Since there is no way of knowing with precision what experience will be in the future, actuaries must use assumptions to simulate experience. A variety of assumptions reflecting the estimated flow of participants through and out of such retirement plans are used in order to estimate the overall flow of benefit payments from a plan. Specific assumptions relative to patterns of employee disability, death, retirement, and general turnover are used in such studies. If benefits are based on pay, estimates of future pay increases are made in order to estimate the amounts of such benefits. In addition, longevity after retirement, disability, etc. is simulated in order to estimate the duration of benefit payments.

The resulting estimates of the amounts and timing of benefit payments from the plan are then reduced to present value using the assumed time value of money (rate of investment return). This present value represents the value today of all estimated future benefit payments to be made from the subject plan.

The actuary then applies a set of techniques called an "actuarial cost method." An actuarial cost method is used to convert the actuarial present value of future benefits, described above, to a range of annual contributions which will support those benefits. The basic concept underlying most of these methods is not dissimilar to that used by financial institutions in converting mortgage amounts to monthly payments for home buyers.

As we can see, from the above discussion, there are several things which heavily impact the results of actuarial valuations:

- (1) The Provisions of the Plan - It is the provisions of the plan that will determine when individuals are eligible for benefits and how much those benefits are to be.
- (2) The Group of Employees to be Covered - The characteristics of the group to be covered is a vital ingredient in the results of actuarial calculations.
- (3) Actuarial Assumptions - As with any set of assumptions used in statistical projections, there is a degree of variability in assumptions that are considered to be appropriate. However, it is clear that actuarial assumptions are a key ingredient in the results of any actuarial study.
- (4) Actuarial Method - The levels of contribution generated by any actuarial study are sensitive to the actuarial method used.

It must be understood that the real cost of any retirement plan is not the actuary's estimates. The real cost of any retirement plan is the actual benefits that are expected to be paid from the plan and any administrative expenses involved in paying those benefits. That cost is supported over the long-term life of the plan by contributions and investment returns. Thus, an actuarial determination of contributions to be made to a retirement plan is only an estimate of the cost of the plan and an attempt by the actuary to provide information to the plan sponsor that will allow for an orderly accumulation of assets to cover the obligations generated by the set of promises that is a pension plan.

What Characteristics of Plans and of Plan Sponsors Can Lead to Underfunding

This is a very broad and a very difficult question. We must first attempt to define what we mean by an "underfunded" plan. In the context of this hearing, we will assume that underfunding means that at the time of the termination of a retirement plan there are insufficient assets to support the benefits which have been accrued by the participants in the plan.

Funding a pension plan is, by nature, a long-term venture. In performing actuarial valuations described above, the actuary normally assumes that the plan is to be an ongoing entity. Benefits under the plan are generally earned over a long period of time and such benefits are funded over a long period of time. Because of the long-term nature of pension funding, benefit accrual and asset accumulation do not generally follow parallel paths. If a plan termination cuts short that period, the plan may or may not have accumulated sufficient assets to provide the promised benefits.

Some actuarial cost methods actually are designed to produce an excess of assets over the actuarial present value of accrued benefits during the early years of a plan in order to stabilize the costs of a plan. If a plan terminates during this period of the plan's

development, the plan may have assets that are more than sufficient to cover accrued benefits and a reversion may result.

On the other hand, many retirement plans have a history of regular benefit improvement. For example, if a plan which currently provides a benefit of ten dollars per month per year of service is amended to provide fifteen dollars per month per year of service, that benefit is available immediately. That plan may have been well funded before such a change. However, upon adoption of such an amendment, the commitment for the payment of benefits increases by 50% while assets do not change. The financial effect of such a change is amortized over a period up to thirty years. Thus, it will take a number of years for the financial status of the plan to return to the pre-amendment level. As a result, if that plan terminates within thirty years after the adoption of such an amendment, some of the funding for that amendment will probably not have been made. In the real world, such changes may occur at intervals of two to five years (although a 50% increase in benefit levels at one time is unusual). Thus, at any point in time, a plan sponsor may be amortizing the effects of many such plan amendments. This dynamic can be a cause of underfunding of plans at termination.

There are a number of other factors which can contribute to a plan having insufficient assets upon termination to cover the benefits accrued. For example, rapidly growing employers face two problems in funding pensions. First, they may be adding staff rapidly and, while new staff may initially have little benefit accrual, this will grow rapidly. Second, such business growth must be financed, with operational and capital funding needs taking priority over pension funding.

Another situation deserving review is the non-multiemployer negotiated plan. In such a situation, it is in the interest of both labor and management to fund at minimum contribution levels. From the standpoint of labor, the largest benefit supportable by the contribution level of the plan is to be pursued. From the standpoint of management, it is fruitless to fund at levels greater than the minimum as continuing gains will probably result in increased benefits negotiated. The termination of such a plan can result in an underfunded condition.

Finally, a retirement plan is only as healthy as the employer or the industry which underlies it. Even though a plan may be well funded today, continuing contributions must be made in order to sustain funding levels. Employers or industries in difficult financial conditions may find it difficult to make appropriate levels of contribution, even under the minimum funding requirements of the Internal Revenue Code (IRC).

In summary, while there are general conditions which may give rise to such underfunding, it is difficult to generalize the conditions which will result in underfunding at plan termination.

Impact of Federal Regulation

For a long period of time, federal regulation has impacted the private pension system. Prior to 1974, Internal Revenue Service (IRS) requirements relative to minimum and maximum contribution levels had a major impact on the funding of retirement plans in the United States. Since 1974, federal regulation has clearly impacted pension funding substantial extent.

The minimum funding standards (Section 412 of the IRC) and the regulations thereunder have established a solid, well-defined set of minimum funding goals for private pension plans. The minimum funding standards provide guidelines to actuaries in terms of the actuarial methods that can be used, the manner in which actuarial assumptions are selected, the extent of employee information to be used in these valuations, and the periods over which certain types of actuarial liabilities are to be amortized. Thus, constraints on the funding of pension plans are well defined.

The minimum funding standards require the use of actuarial assumptions which, in the aggregate, reasonably reflect the actuary's best estimate of anticipated experience. Only actuarial methods that are recognized by the IRS as reasonable funding methods can be used in calculating contribution rates relative to these plans. The general thrust of the minimum funding standards, as adopted in 1974, was to insure that sufficient assets are accumulated, in an orderly way, to support the obligations of the plan.

However, these standards are not unsympathetic to an employer in financial trouble. While there are tax penalties for funding deficiencies, there is a procedure for waiving funding deficiencies of distressed employers. It would clearly be unreasonable to insist so strongly on pension funding that, by virtue of that insistence, the jobs underlying the retirement plan are eliminated.

There are other areas of federal law, however, which work in the opposite direction. Contributions to qualified pension plans are tax deductible to the employer in the year paid, with no tax consequences to plan participants until benefits are paid. To the extent that such contributions are tax deductible, they impact federal revenues. In this era of substantial federal deficits, the revenue question is an important one.

An example of an IRC provision, the focus of which is in conflict with the goal of adequate pension funding is the benefit limits of Section 415. The benefit limits of Section 415 of the IRC are designed to limit the amount of dollar benefit which can be paid from a qualified pension plan. It is understood that the dollar limits of Section 415 are to be indexed to the Consumer Price Index during and after 1988. Thus, the dollar limits of Section 415 will be increasing regularly and consistently over time. However, IRS regulations will not allow actuaries to recognize future increases in those limits in the calculation of contributions to retirement plans. As a result, plans, by virtue of this regulation, are being encouraged to underfund the benefits that they are promising.

For example, assume we have a participant in a pension plan currently age fifty-two. Let us assume further that this individual will stay in active participation and retire at age sixty-five. The maximum benefit payable currently at age sixty-five is \$90,000 per year. If we assume that the limits of Section 415 will increase at a rate of about 3% a year, that maximum will be over \$150,000 by the time this individual retires. Under current regulations the plan sponsor may fund only the benefit of \$90,000. Thus, this regulation requires the plan sponsor to fund to a benefit which is perhaps, 60% (in this case) of the benefit which the individual will ultimately receive.

Another example of this phenomenon occurs in H.R.3838. This bill contained a provision which would assess a penalty tax of up to 30% against plan sponsors who understate their tax liability by overstating pension tax liabilities. The purpose of this provision was apparently to attack the perceived use of the pension portions of the IRC as a tax shelter. The Academy is very much concerned about such alleged "abuse." However, this provision would affect the funding decisions of most sponsors of defined benefit pension plans. While we cannot quantify the effect of such a provision, we are certain that it would not encourage appropriate funding of private pension plans.

These are only examples of the basic conflict which currently exists in the making of policy relative to pension funding. It is important that retirement plans have sufficient assets to pay the pensions which they are promising. It is important in the conduct of commerce that such assets be allowed to accumulate in an orderly manner. However, there currently seems to be a conflict at the policy level between the impact of pension contributions on federal revenues and concern for appropriate funding of private pension plans.

Age of the Private Pension Industry

It is interesting to note that the private pension industry is still relatively young. There was only a span of twenty-five years from the date of the Inland Steel decision, which established the concept that pension plans were proper subjects of collective bargaining, to the enactment of ERISA. In evaluating the progress of the private pension system during that twenty-five year period and the eleven year period since ERISA, we must note that even today the private pension movement is still a relatively young one. The numbers of retirement plans grew rapidly during the initial twenty-five year period and with that growth in numbers of plans, funding, which of course started slowly, improved substantially. Funding has continued to improve over the last ten years. Part of this improvement can be traced to the growing maturity of private pensions, while some of it can be attributed to the minimum funding standards in ERISA.

Of course, the numbers of new defined benefit plans has dropped substantially and many defined benefit plans have terminated during the post-ERISA period. We find this trend to be alarming. This trend has been attributed to a number of factors:

- (1) The desirability of using working capital in operations rather than tying it up in pension funds;
- (2) Concerns relative to corporate takeovers;
- (3) The expected impacts of the new accounting standards recently announced; and
- (4) An uncertain and rapidly changing regulatory environment.

There are a number of sound social and economic reasons for the desirability of a solid, growing private pension movement. Such growth, in the defined benefit pension area, has virtually stopped in terms of numbers of plans. While the first three of the reasons listed above for this trend are difficult to control in the current economic environment, the fourth (and in our opinion, most significant of the reasons) is subject to congressional control.

The Future

In spite of the fact that actuaries make projections, we do not have the exclusive use of the crystal ball. We truly do not have a feel for what the future will bring. However, there are trends that are disturbing. First, there is a movement away from defined benefit plans toward defined contribution plans. This movement is the result of a number of factors already cited. However, we feel the most significant factor is the uncertainty of the regulatory environment.

Since 1982, there have been three major legislative enactments relative to qualified retirement plans which have required virtually every plan in the United States to be amended. The Congress is in the process of debating a fourth set of changes in the tax reform package. We would like to suggest that the best thing that could be done for the private pension system in the United States would be to stabilize the regulatory environment. That is, to establish policy and then to leave it alone to operate.

A parallel hope is that the current conflict between federal revenue concerns and pension funding considerations can be resolved at a policy-making level. We would hope that the future of participants in private pension plans will not become the subject of future short-term debates over federal revenue.

The graying of America continues and is expected to continue well into the twenty-first century. Along with defined contribution plans, defined benefit pension plans have a solid role to play in the retirement security of older Americans. It is to be hoped that the trend to termination of such plans, with or without sufficient assets to support promised benefits, can be curtailed and that such plans will be allowed to operate in a stable, certain regulatory environment over the long-term future.

Summary

In summary, the nature of pension funding is such that problems inevitably arise when the time for accumulation of assets and accrual of benefits is cut short by plan termination.

While the minimum funding standards certainly provide a solid guide for funding, there is no practical way to insulate pension plans from the financial problems of their sponsoring employers and industries.

We would suggest that stability of the economy underlying the sponsors of pension plans is the most effective means of stabilizing private pension financing. In addition, the stabilization of the regulatory environment for private pension plans would establish a positive environment for these plans which provide post-retirement income to millions of citizens of the United States and promise such security to the current generation of workers.

AMERICAN ACADEMY OF ACTUARIES PENSION COMMITTEE

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STATEMENT OF
THE ERISA INDUSTRY COMMITTEE
TO
THE SUBCOMMITTEE ON OVERSIGHT
AND
THE SUBCOMMITTEE ON SOCIAL SECURITY
OF
THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
JOINT HEARINGS ON PENSION PLAN UNDERFUNDING

JUNE 24, 1986

My name is Kenneth W. Porter. I am the Chief Actuary of E. I. du Pont de Nemours & Company, Inc. I appear today on behalf of The ERISA Industry Committee, commonly known as ERIC. ERIC is an association of more than 100 of the nation's largest employers. ERIC's members maintain retirement and savings plans covering some 10 million participants and beneficiaries.

ERIC's members share with the subcommittees a deep interest in the success and expansion of the private pension system. We have been witnessing in recent years a remarkable growth of the private pension system.

Summary

We believe that ERISA's funding standards assure a satisfactory rate of plan funding that is consistent with both the need to protect participants and beneficiaries against underfunding and the need to give employers sufficient flexibility to encourage them to participate in our nation's voluntary private pension system. We believe that the Internal Revenue Service has sufficient authority under existing law to enforce the current pension funding standards.

At the same time, current provisions of the Internal Revenue Code -- particularly the Section 415 limits on benefits and funding -- impede sound pension financing. Furthermore, a number of the provisions in the pending tax reform bill would also interfere with the funding of pension plans.

Discussion

ERIC's members have a long-standing and serious commitment to the sound funding of private pension plans. This commitment is based on our recognition of the vital role that the private pension system plays in providing retirement security for our nation's workers and on the realization that private pension plans will not be able to fulfill that role unless they are funded sufficiently to deliver the benefits that they promise.

Sound pension funding requires an employer to fund pension benefits for its employees many years in advance of the time that the employees actually retire. If an employer could not fund its employees' pensions in advance, the security of its employees' pensions would depend on the employer's financial condition after the employees retire

and thereby jeopardize their retirement security. Adequate advance funding for pensions was a primary goal of ERISA.

The termination of an underfunded pension plan can have serious adverse consequences for the employees and beneficiaries who are covered by the plan, for the employer that sponsors the plan, for the Pension Benefit Guaranty Corporation ("PBGC"), which insures benefits under terminated plans, and for the other plan sponsors that must pay premiums to the PBGC.

Although the PBGC insures certain benefits under terminated plans, all plan benefits are not covered by PBGC insurance. Thus, a plan termination can cause employees and beneficiaries to lose a portion of the benefits that the plan had undertaken to provide. To the extent that PBGC insurance applies, the loss is shifted from the participants and beneficiaries to the PBGC which, in turn, must cover its losses by collecting employer liability payments from the employer that sponsored the plan and by collecting mandatory premium payments from the employers that sponsor plans that have not terminated. Thus, ERIC's members, as the sponsors of on-going pension plans, have a strong interest in the sound funding of both their own plans and the plans of other employers.

At the same time, ERIC recognizes that the private pension system is a voluntary system and that any funding standards that made unreasonable demands on plan sponsors would discourage the formation of new plans and the expansion of existing plans. Excessively stringent funding standards also could cause the termination of many existing plans.

Minimum funding standards must strike a balance between the need for pension plans to be soundly funded, on the one hand, and the need to preserve and expand the voluntary private pension system, on the other. We think that ERISA strikes an appropriate balance between these two competing needs. ERISA's minimum funding standards are rigorous; they require immediate funding of a plan's current (or normal) costs and amortization of past service costs over a 30-year period; and experience losses and other losses also are required to be amortized over specified periods. At the same time, the funding standards are not so onerous that they discourage responsible employers from establishing or maintaining pension plans.

Only recently, in the Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA"), Congress strengthened the funding standards and reduced the incentive that some employers may have had to terminate underfunded pension plans. In COBRA, Congress authorized the Internal Revenue Service to require an employer to provide security to a plan before the Service would grant the employer a funding waiver or an extension of an amortization period. In addition, COBRA limited the circumstances in which an employer could terminate an underfunded plan to cases of serious financial distress.

We believe that ERISA and COBRA are more than sufficient to assure a satisfactory rate of plan funding. We believe that any further constraints on funding rates would not be productive and could jeopardize the vitality of the voluntary private pension system.

In our judgment, the focus should be on what is being funded, rather than on the rate of plan funding. The term "funding objective" is commonly used to refer to the measure of what is being funded. A plan's funding objective depends on the benefits it provides, the size and characteristics of the work force that it covers, and the actuarial assumptions that are used to determine the current value of its obligation to pay benefits in the future.

ERISA's funding standards require that, in the aggregate, the plan's actuarial assumptions and methods be reasonable and offer the actuary's best estimate of anticipated experience under the plan. The Internal Revenue Service has ample authority to enforce this standard, and it is our understanding that the Service has recently intensified its review of the actuarial assumptions being used for funding purposes. We believe that the Service's existing authority is adequate to curtail the use of unreasonable actuarial assumptions and that there is no need for additional legislation in this area.

In pension funding, it is necessary to fund on the basis of a set of actuarial assumptions that represent a reasonable middle-of-the-road scenario about future economic conditions. Because no one really knows what will happen in the future, a range of assumptions can be considered reasonable for the long-term. No actuary or plan sponsor expects the assumed scenario to be exactly realized, but he or she expects that economic volatility will eventually produce nearly offsetting gains and losses.

Economic cycles, however, usually take years to complete, and it is not uncommon to experience several years of losses followed by a trend toward gains. For example, during the period of double-digit inflation that we encountered in the late 1970's and early 1980's, pension promises increased much more rapidly than any of us could have anticipated when we began complying with ERISA's minimum funding requirements around 1976. During that period of growing liabilities, investment yields were disappointing, and the funded status of pension plans generally deteriorated. In addition, because of the strain of high inflation on businesses in general, it should come as no surprise that a number of underfunded pension plans were terminated.

We should be cautious against the over-generalization that these terminations were all the result of either poor management or inadequate minimum funding laws and regulations. Rather, history now demonstrates that this period was a severe fluctuation in the economic conditions that influence the long-term pension funding commitment. Subsequent to the period of high inflation, we experienced unprecedented real earnings on pension trust assets while

pension liabilities began to grow more slowly than anticipated as inflation subsided, and pension plans became better funded. However, as I will explain, the funded status of many plans has been distorted by the benefit limits imposed by the Internal Revenue Code.

Over this entire economic cycle, funding objectives have been systematically reduced by repeated reductions in the benefit limits imposed by the Internal Revenue Code and the way those limits must be used in pension plan funding. When it enacted ERISA in 1974, Congress added Section 415 to the Internal Revenue Code to limit the benefits that can be funded and paid under a tax-qualified pension plan. Although the limit was initially \$75,000 per year, the \$75,000 figure was indexed for inflation. However, the 1982 and 1984 tax bills reduced the dollar limit and suspended the indexing feature until 1988. As a result, the limit for a pension plan is now \$90,000, the level at which it was frozen in 1982.

The ability to fund for an adequate retirement benefit is lower today in real terms than it was in 1974 when ERISA was enacted. Reducing and freezing 415 limits means that more and more workers can have their pension benefits cut or made dependent on the financial condition of their employers in the future.

It bears emphasis that the \$90,000 limit not only limits the amount of the benefit that may be paid by a tax-qualified plan, but also precludes an employee from funding any future benefits in excess of the limit. After the enactment of ERISA, the Internal Revenue Service took the position that a pension plan should be funded on the assumption that the dollar limit imposed by Section 415 was not indexed. In 1982, Congress codified the Service's position as part of the Tax Equity and Fiscal Responsibility Act ("TEFRA"). As a result, the Section 415 limits often have the effect of preventing employers from adequately funding their pension plans.

Nearly all ERIC members have one or more defined benefit pension plans under which an employee's pension is based on his or her rate of compensation. Under a plan like this, the plan's ultimate liability to pay benefits to an employee will depend on the employee's future rate of compensation. As a result, the employer's funding objective must take into account the actuary's expectation regarding future compensation increases for the employees covered by the plan. However, the Internal Revenue Code prevents the actuary from taking into account any future benefits in excess of the current Section 415 limits, even though the actuary's best estimate typically will indicate that, as a result of anticipated future compensation increases, many employees ultimately will be entitled to benefits that exceed the current Section 415 limits. In these circumstances, the Section 415 limits clearly have the effect of preventing the employer from adequately funding its pension plan.

As a result of the change in economic conditions and the reduction and freezing of the Section 415 limits,

what had appeared to be a deteriorated funding position of pension plans in the late 1970's and early 1980's now appears to have been turned around, and we have seen a dramatic increase in the number of pension plans that are fully funded. The chances of a plan terminating today with inadequate assets appear to be much less than it was just 18 months ago. In fact, contributions to a number of pension plans have even been suspended because the pension trust asset values exceed the ERISA full-funding limitation. However, because of the Section 415 limits, the ERISA full-funding limitation is an inadequate measure of the future assets needed by the plan. While many plans now appear to be fully funded, this apparent full funding is frequently attributable to the fact that the Section 415 limits prevent the employer from adopting a realistic view of what the plan's ultimate liability will be.

I expect history will show that the current high level of pension assets also represents a relatively short-term fluctuation in the economic conditions that influence the long-term pension funding commitment. But there are no guarantees and, while we are waiting for history to unfold, more and more companies are suspending contributions because of the artificial limitations imposed by the Internal Revenue Code.

This is best illustrated by example. Consider the typical mature corporate pension plan that has been funded conservatively over the years, supported by management's genuine desire to provide a secure pension for its employees. Prior to ERISA, there were no Section 415 limits restricting benefits, and funds were properly set aside to provide the full projected pension promise. ERISA imposed a limit on benefit payments but still permitted the funding objective to include the vast majority of the projected pension promise. Subsequently, however, the Section 415 limits were dramatically reduced, and the use of projections in excess of the limits was prohibited.

The plan has assets on hand today that were properly accumulated in the past to pay for the full projected pension promise, but now these assets cannot be used for any purpose. Since the plan is now viewed as "fully funded," and no contributions are being made, the excess assets cannot be used even to reduce future contributions -- unless, of course, asset values drop significantly, in which case the plan will then appear more underfunded as a result of the current suspension of contributions. Despite the fact that the employer had previously funded toward higher projected benefits, the employer must now finance for a second time the part of each benefit that exceeds the Section 415 limits. This second financing will come out of the employer's on-going operating income as benefits are paid.

The reduction and freezing of the Section 415 limits have thus artificially curtailed pension funding. We urge the subcommittees to resist the efforts now being made, in connection with the pending tax reform bill, to reduce Section 415 limits yet again. Such reductions would further

impair the ability of employers to fund their pension commitments on an actuarially sound basis.

We have also identified two other legislative proposals that also may curtail the funding of pension plans.

In recent years, a number of proposals have been made to prevent or discourage an employer that terminates a fully funded pension plan from recovering the plan's excess assets -- the assets that remain after the plan has satisfied all of its liabilities. The pending tax reform bill, for example, would impose a nondeductible excise tax on an employer that recovered excess assets from a terminated plan.

These proposals will strongly discourage employers from funding their plans on a conservative basis. Since funding in excess of the ERISA minimum funding standards is a voluntary act by the employer, many employers are likely to conclude that if their ability to retrieve any excess funding is in doubt, they will reduce their pension contributions rather than commit funds that they may never be permitted to recover.

In addition, the minimum tax provisions in the Senate tax reform bill provide that the income that is subject to the alternative minimum tax on corporations will include one-half of the amount by which the corporation's adjusted net book income exceeds the corporation's "alternative minimum taxable income." Recent pronouncements issued by the Financial Accounting Standards Board (FASB Nos. 87 and 88) require an employer to report pension income rather than pension expense for financial reporting purposes where its plan is well funded and the plan has experienced substantial actuarial gains.

As a result, a number of ERIC's members believe that under the Senate bill, a corporation could be penalized -- by being subjected to higher taxes -- for having funded its pension plan conservatively and having the pension assets invested successfully. By contrast, it appears that under the Senate bill, if the corporation's plan is underfunded, the corporation may report a net pension expense and thereby reduce its liability for the minimum tax. It thus appears that the Senate proposal may discourage the sound funding of some plans.

The message is coming across loud and clear. If the employer takes a middle-of-the-road view of the funding objective and later finds out that unforeseen economic conditions result in an overfunded plan, the employer could be penalized and the excess assets could be lost forever. On the other hand, if the employer aims toward a lower funding objective and the hoped-for gains do not materialize, additional contributions can always be made without penalty as long as the employer remains a viable entity. Unfortunately for the plan participants, there is no guarantee that the employer will remain viable. And, if the employer fails, the pension plan will tend to be less well funded.

In sum, we are seriously concerned that the current Section 415 limits, the proposed reductions in the limits, the proposed restrictions on reversions of pension assets, and the Senate's proposed minimum tax provision tend to discourage sound pension funding and diminish the retirement security of the tens of millions of employees and beneficiaries who rely on pension plans for retirement income.

We very much appreciate the opportunity to present our views to the subcommittees. We will be pleased to provide the subcommittees and their staffs with any additional information or analysis that would be helpful to them.

Thank you very much.

STATEMENT
OF
THE ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS

Mr. Chairman, Members of the Subcommittee, I am Vance Anderson of the Mobil Oil Company. I am here today representing the Association of Private Pension and Welfare Plans ("APPWP"), on whose Board of Directors I serve. The APPWP is a non-profit organization founded in 1967 with the primary goal of protecting and fostering the growth of this country's private benefit system. The APPWP's 475 members represent hundreds of plan sponsors as well as the leading organizations that support the nation's private employer-sponsored benefits systems' investment firms, banks, insurance companies, accounting firms and actuarial consulting firms. Collectively, APPWP's membership is involved directly with the vast majority of employee benefit plans maintained by American industry.

We are pleased to be able to testify before you today because for a variety of reasons, the problem of underfunding in defined benefit plans needs to be put in perspective. The termination insurance provisions of ERISA, as well as the minimum funding standards in the Internal Revenue Code, were enacted in large part in reaction to the perceived problems of underfunding that existed in pension plans prior to 1974. In the ten years that followed the enactment of ERISA, the overall track record of plans has been very good. In judging whether Congress needs to address underfunding in plans, one cannot overlook the fact that most of the attention that defined benefit plans have received from the Congress in recent years has focussed on overfunded plans. The surplus assets that these plans enjoy at plan termination have been the subject of considerable comment as have the maximum funding limitations of IRC sec. 404. As you know, we have advised against the successive funding limitations adopted by this committee in 1982, 1984, and in H.R. 3838. In our view, the fact that the majority of today's defined benefit plans are well-funded is an indication that the funding standards in the Code and ERISA have worked as they were intended.

Clearly, of course, some plans continue to be seriously underfunded, as the testimony of earlier witnesses has pointed out. As the effects of the recent tax bills work their way into the system, we expect additional numbers of plans to become "more funded" against today's standards. While some 98 percent of all plans terminating under the PBGC procedures are sufficiently funded for guaranteed benefits, those plans which have terminated with insufficient assets seem to have exposed the termination insurance system to larger amounts of liability per plan than in the early years after ERISA. As premium payers, we are concerned at the large losses that the PBGC has had in the last few years and the strain on the premium required of all employers to cover these losses.

The causes of the underfunding vary from plan to plan, but our impression is that underfunded plans are more numerous in troubled industries, where severe layoffs and early retirements have resulted in actuarial assumptions not being achieved. Furthermore, in those same situations, there is a natural but lamentable tendency to defer funding in favor of more immediate financial requirements. In addition, waivers of the minimum funding standards during periods when the plan sponsor experiences serious cash flow problems have exacerbated the underfunding. The recent amendments to Title IV of ERISA should encourage better funding, because ongoing employers will be unable, at plan termination, to use the 30 percent of net worth cap on liability as a shield to avoid paying for the benefits they have promised. In addition, the new legislation will make funding waivers less attractive since the amounts waived will accrue interest at a market rate of interest, rather than the ordinary low plan funding of interest.

Thus, we expect that the amendments to Title IV will encourage better funding of plans. We find it hard to fathom, however, the current support in Congress for tax proposals which would have just the opposite effect. Chairman Rostenkowski, in announcing these hearings, emphasized his interest in seeing a

comprehensive review of the goals and performance of the current retirement income system. We testified at those earlier hearings and applauded your subcommittees' efforts to impose legislative consistency on a set of recognized goals, including particularly the goal of improving funding in defined benefit plans. Yet, during the period over which your hearings have been held, Congress has also been addressing major revisions to the Internal Revenue Code which directly affect pension plans in general, and the funding of those plans in particular.

In our view, no review of the problems of underfunded plans would be complete unless we analyze the effect of the proposed changes in the House and Senate tax reform bills on the Code section 415 limits on benefits in defined benefit plans. These limits have been the subject of revision three times in the last 12 years, with each change jeopardizing the funding of qualified plans. In 1974, Congress imposed a \$75,000 limit on annual benefits under a defined benefit plan, but allowed for annual indexing; in 1982, Congress reduced the limit once again from the then-indexed amount to \$90,000 and delayed further indexing until 1986; in 1984, Congress further delayed the indexing of the \$90,000 limit until 1988. Average wages in the period since 1975 have increased by almost 100 percent and the value of the dollar has gone down by about a third. The section 415 limits have not nearly kept pace. As a percentage of pay, the amount an employee can receive from a defined benefit plan has already been drastically reduced. Despite this fact, the House, in H.R. 3838, proposed a reduction in the section 415 limits to \$77,000 for defined benefit plans, with indexing of post-1986 changes in the cost of living not to begin until 1988. The Senate Amendment to H.R. 3838, while it appears to retain the \$90,000 limit, removes the window provisions which protect against actuarial reduction of benefits commencing between the ages of 62 and 65. Thus, because the great majority of American workers have tended to retire between age 60 and 62, the limit would be effectively reduced to \$67,500 at age 62 and \$56,456 at age 60. In addition, the Senate Amendment would remove the \$75,000 floor on the limit for benefits commencing after age 55. Under the Senate bill, a participant who had accrued a \$90,000 benefit at age 65 would be limited to an annual benefit of \$37,405 at age 55.

Under either of the current tax reform bills, the defined benefit limit would take another beating, and one that would directly affect the ability of plans to adequately fund promised benefits. Plan sponsors may only fund for the defined benefit limit that is currently in effect. Increases due to indexing may not be funded for until the increased limits become effective. Thus, when funding for the retirement benefit of a 30 year old today, projected salary increases until retirement age may be taken into account, but the value of his retirement benefits 35 years from now is capped for funding purposes at the section 415 limit, which under the House bill may be as low as \$77,000 commencing at age 65. However, as more and more people retire early, pegging benefit commencement at age 65 becomes totally unrealistic, and the actual cap on benefits will be at a far lower level. Employers will be forced to reduce their annual contributions to the plan because of the reduction in the section 415 limits so that the amounts set aside for retirement will likely be inadequate when measured against the true costs and liabilities of the plan. The fact that more and more employees will be subject to benefit uncertainty is illustrated by the dramatic increase in the number of people who will depend on excess benefit plans -- those plans which under ERISA are designed to make up the difference between benefits under the plan and benefits as permitted by the section 415 limits. By law, these plans must be unfunded. We have polled nearly a dozen large companies which had established such plans in the mid-1970's when the section 415 limits were first enacted. At that time, these companies report that less than a half dozen participants were covered under the excess benefit plan. As wages have increased and the section 415 limits have effectively been steadily lowered, employees whose benefits depend on the excess plan have increased enormously.

Even under the current limits, the percentage of participants counting on benefits from an excess plan reached, in our informal polling, as high as 38 percent of the company's workforce. Under the House bill, that percentage is expected to increase by about 10 percentage points. Under the Senate bill, the percentage would increase by 15 percentage points or more.

The chances that an employee's benefit will be adequately funded depend entirely on the plan sponsor's ability and willingness to make up the prior year funding deficit for increases in his legally permitted benefits after the increases are effective. Some employers may be willing and able to do so; others, because of industry conditions or financial instability, will not have the wherewithal to fund these increases as rapidly as necessary. Thus, instead of the funds being set aside in trust for the exclusive benefit of participants, retirement benefits will increasingly depend, as they did prior to 1974, on the financial ability of the plan sponsor to meet his pension promises. The result, unfortunately, for the future, is to suffer the same mistakes of the past with respect to funding of retirement benefits. We fail to see how this result is in any way consistent with the concerns expressed today. While the Congress holds hearings to study the causes of underfunding in plans, it simultaneously approves legislative proposals which undermine sound funding. We urge you to consider carefully the effects of lowering the section 415 limits, with the deliberate impact it will have on plan funding, before Congress acts in contravention of the expressed goals it has set for defined benefit plans.

STATEMENT
on
PENSION PLAN UNDERFUNDING
before the
SUBCOMMITTEE ON OVERSIGHT
and the
SUBCOMMITTEE ON SOCIAL SECURITY
of the
HOUSE COMMITTEE ON WAYS AND MEANS
for the
U.S. CHAMBER OF COMMERCE
by
Thomas A. Jorgensen
June 24, 1986

Chairman Pickle, Chairman Jones, and members of the Subcommittees, my name is Thomas A. Jorgensen. I am a partner in the Cleveland, Ohio law firm of Calfee, Halter & Griswold. I serve as a member of the Employee Benefits Council of the U.S. Chamber of Commerce and Chairman of its Task Force on Single Employer Pension Plans and am pleased to appear today on behalf of the Chamber to address the issue of underfunded pension plans. Accompanying me is James A. Klein, the Chamber's Manager of Pension and Employee Benefits.

The Chamber commends you for holding this hearing on the important issue of the funding status of pension plans. As the source of financial support of the Pension Benefit Guaranty Corporation's (PBGC) pension termination insurance system through premiums, private-sector employers have a considerable interest in ensuring well-funded plans. It is a fundamental element of the Chamber's pension policy declarations that responsibly funded plans are important to our members and their employees.

UNDERFUNDED PENSION PLANS

At the outset, it is important to note that underfunding may mean different things in different contexts. A plan that terminates with insufficient assets to pay all accrued benefits is an underfunded plan that may pose a threat to plan beneficiaries, the PBGC and to other businesses that support the PBGC. On the other hand, an ongoing plan may be less than fully funded yet pose no real risk that benefits will not continue to be paid. From a public policy perspective, it is important that we encourage responsible funding of plans so that ongoing underfunded plans improve their funding status and not terminate in an underfunded condition to the detriment of both beneficiaries and the fiscal integrity of the plan termination insurance system.

A number of patterns of underfunded plans -- or at least factors that contribute to underfunding -- are apparent.

The study undertaken by the General Accounting Office (GAO) at the request of Chairman Pickle undoubtedly will shed light on certain common features of underfunded plans. If the GAO findings mirror what one would expect based upon anecdotal experience with private pension plans, the GAO report likely will show that the great majority of pension plans in this country are funded adequately but that some plans do suffer from underfunding.

We believe that studies of underfunded plans will indicate that the plans that are underfunded are generally pension plans that provide a "flat dollar benefit" -- such as \$10 times the participant's years of service for the employer. This type of plan has been for years the prototype plan for hourly paid workers in the industrialized sector of America -- regardless of whether the employees are union or nonunion. As discussed below, federal policy not only discourages adequate funding of this type of plan but also often prevents plans from being funded adequately. Other types of plans besides flat dollar benefit plans also may be underfunded, and the reasons for those underfunded situations also are discussed below.

THE CAUSES OF UNDERFUNDING

Many factors contribute to underfunding.

The first factor often is that an employer is permitted to adopt a plan that provides benefits for employees' prior service, but Section 412 of the Internal Revenue Code does not allow a tax deduction for the adequate funding

of such benefits. Typically, when an employer adopts a flat dollar benefit plan, the plan provides benefits for the employees' prior service. This is logical because the plan is generally being adopted to meet the needs of the long-term employees. What is not logical is that even if the adopting employer wants to fund for this past service liability, it is unable to do so and take a deduction for such funding.

The second factor is that benefits payable from a flat dollar plan are not based upon the compensation of employees, and the only way for the benefits to increase to reflect inflation or higher pay levels of the participants is by plan amendment. Typically, plan amendments increasing benefits have occurred every few years. During the highly inflationary period of the 1970's, it was not unusual for the benefits under this type of plan to double or triple in a relatively short period.

Under the funding rules, benefit increases must be amortized over a period of 10 to 30 years, even though they will be insured fully by the PBGC in five or fewer years. With pension benefit increases occurring every few years and funding at a rate faster than 10 years effectively prohibited, the flat dollar pension plan can never reach full funding status.

A third factor is pension plan provisions that trigger benefits upon the occurrence of certain events (e.g., the closing of a facility, the cessation of the employer's business, or the termination of a certain collective bargaining unit). Such provisions frequently are contained in flat dollar benefit plans that typically cover the employees of a certain collective bargaining unit or facility. Since the lifespan of such a pension plan is unpredictable and the plan may cease to exist suddenly, the benefits that are triggered pursuant to the plan's provisions may not be funded at the time the plan terminates.

A fourth factor is the number of waivers to the minimum funding standards that are granted by the Internal Revenue Service. Funding waivers are by no means necessarily negative. It is important to remember that companies seeking such waivers are often those that might otherwise have to reduce severely or cease operations if the waivers are not granted. Clearly, in such a situation, massive layoffs or cessation of business operations poses a more serious danger to the well-being of the company's employees and to the pension termination insurance system than the granting of a funding waiver. Nonetheless, numerous waivers can diminish a plan's funding status with potentially greater adverse consequences when the plan ultimately terminates.

The Chamber is pleased that among the reforms to the single employer pension termination insurance system that were enacted as part of the Consolidated Omnibus Budget Reconciliation Act (COBRA) is a requirement that the PBGC (which bears the risk of underfunded plans) be notified when the IRS receives a funding waiver application. Moreover, under COBRA the IRS is permitted to require "security" as a condition of granting funding waivers.

Related to the issue of funding waivers is the fact that benefits continue to accrue during periods when funding waivers are in effect. This can be problematic. If the employer cannot afford to make contributions for benefits that have been accrued under the plan, it may not be in a financial condition to incur even greater unfunded pension liabilities. Freezing accruals at a time when a funding waiver is permitted might lessen the impact of mounting benefit accruals at a time when the ability to fund a plan is tenuous.

A fifth factor is federal legislation that mandates benefit increases. The provisions of the Retirement Equity Act that require joint and survivor benefit options in all plans diminish the funding status of plans. Likewise, the feature of the Senate version of H.R. 3838, the tax reform measure, that would require five-year vesting can not help but diminish their funding status. Similarly, the new so-called nondiscrimination rules contained in H.R. 3838, by forcing coverage of additional groups of employees, will have a negative impact upon funding levels. The Chamber absolutely believes that pension plans should not discriminate, that the vast majority of plans do not, and that these proposals to change the nondiscrimination rules are unnecessary and precipitous.

Since there has been no Congressional finding of discrimination by plans, it seems unwise to require a new set of coverage rules at this time. Indeed, in the version of H.R. 3838 drafted by the House Ways and Means Committee, only a study of the effect of current nondiscrimination rules was

required. Changing these rules involves substantial administrative costs and burdens and, to the extent that they result in increases in benefits or new coverage for employees, will have a negative effect on funding levels. We strongly urge that the conferees on the tax reform measure not adopt new rules at this time.

THE ROLE OF FUNDING STANDARDS

The minimum funding standards of the Employee Retirement Income Security Act (ERISA) were intended to ensure that pension plans do not become dangerously underfunded. Certainly, for the most part, they have been successful. However, in the case of the flat dollar benefit plan, the funding standards actually inadvertently encourage underfunding. For example, the period for funding past service accrued benefits is 30 years while the same benefits become insured by the PBGC in five years.

The 30-year funding rule was certainly appropriate for benefits that were accrued prior to the adoption of ERISA. Employers needed that length of time as an incentive to maintain plans and to provide benefits for prior years of service. Likewise, since the enactment of ERISA, plans have been adopted or benefits have been increased on the assumption that these benefits will be funded over a 30-year period. As a result, it would be extremely ill-advised for Congress to change the rules for funding benefits already promised. Changing the legal requirements upon which pension plan sponsors have relied would have an adverse cost effect upon employers. We have seen, time after time, that legislative changes that are costly to implement and inconsistent with corporate expectations have a negative effect on the willingness of employers to continue or to establish pension plans.

However, there may be certain types of future benefit increases for which a shorter period of funding may be appropriate. Without endorsing such a proposal, we do note that a limited change of this nature would not upset prior expectations of funding past service accrued benefits and could have a positive effect on future funding levels. Further study by Congress of the effect of benefit increases is necessary before altering funding standards.

THE IMPACT OF UNDERFUNDING

The Subcommittees have inquired as to the effect of underfunding on beneficiaries and the PBGC. Underfunding can have a negative effect on the benefits paid because, even with PBGC guarantees, beneficiaries may not receive their full anticipated benefits. This can occur because the PBGC only ensures up to a specific maximum benefit level and because benefits provided under pension plan provisions in effect for fewer than five years, at time of plan termination, are not fully insured.

Underfunding also has potentially adverse effects on the financial integrity of the PBGC termination insurance system, which is called upon to meet the unfulfilled obligations of terminated plans. We witnessed last year the potentially large financial exposure of the PBGC due to some very large terminations that vastly increased the PBGC's liabilities. Before Congress concludes that there is crisis in the pension system, it is important to remember that relatively few plans among the thousands in existence in this country have funding problems. And still fewer have accounted for the PBGC's deficit.

At the end of Fiscal Year 1984 the PBGC's deficit was \$462 million. By the end of Fiscal Year 1985 that deficit had risen to \$1.3 billion, and it has increased since then. However, it should be noted that in the decade between 1974 and 1984 only six plan terminations resulting in claims of more than \$50 million accounted for 44% of all claims against the PBGC. Hence, addressing the problem of underfunded plans should not be done in such a sweeping manner as to upset the operations and funding patterns of the many responsibly funded plans.

It is critical to remember that the PBGC's financial exposure is actually the exposure of the business community, which, through its PBGC premiums, supports the termination insurance system. What is most troubling, of course, is that as PBGC premiums rise to restore the PBGC's financial stability, employers who responsibly fund their plans (and who pose little or no risk to the insurance system) and their employees who forego potentially higher benefits because the employer must pay higher insurance premiums are those who suffer.

In the long run, the taxpayers themselves may directly pay the price for underfunding if general revenues are needed to guarantee the payment of PBGC-guaranteed benefits.

All of these factors lend credence to the notion that bolstering the funding status of those few plans that do pose a risk to the termination insurance system is important in order to avoid undue burden on the vast majority of plans that are very responsible in maintaining adequate funding. We urge thoughtful examination of PBGC data and the findings of the GAO report, which you have commissioned, to understand better the true nature of the funding status of private-sector single employer plans.

EFFECT OF ERISA AND RECENT LEGISLATION ON FUNDING

As a general premise, funding of plans has improved substantially since the enactment of ERISA. Data reported by the Employee Benefit Research Institute based upon various surveys indicate improved levels of pension funding measured on a termination basis. For example, Greenwich Associates data regarding 1,500 of the largest corporate single employer plans showed that the rate of pension assets to accrued liability rose from a 70% ratio in 1978 to a 95% ratio in 1985. Likewise, data compiled by the Wyatt Company concerning plans with 1,000 or more participants show that the percentage of plans fully funded for accrued vested benefits and total accrued benefits has risen steadily from 1979 through 1985. Though the plans surveyed are not necessarily a representative sample of all defined benefit plans in the country, they do include the large-sized plans that are most likely to pose a risk of greater liability to the PBGC if they terminated in an underfunded status. The improved funding status in the years since enactment of ERISA is what we would expect given ERISA's funding standards provisions, the increases in interest rates and a strong stock market.

It is important to note, however, that prior to ERISA certain companies and their employee representatives negotiated for certain levels of funding. Since the advent of the PBGC termination insurance system, however, there may be a tendency among some employers and employee groups to assume that adequate funding levels are not essential since PBGC benefit guarantees exist.

In addition, economic conditions that have nothing to do with ERISA have had an effect on funding levels. Periods of high inflation have meant that pension assets have increased. By the same token, however, high inflation has induced some employees and employers to negotiate for increases in past service benefits that will require between 10 to 30 years to be funded.

The most recent legislation that probably will affect pension plan funding levels is the Single Employer Pension Plan Amendments Act (SEPPAA) which was incorporated into the COBRA, which was signed into law this past April. The Chamber is pleased to have had a role in the development of provisions of SEPPAA that have made structural improvements to the termination insurance system. While not all provisions of SEPPAA are beneficial from the business community's perspective nor all reforms sufficient, the new circumstances under which funding waivers now may be granted and the circumstances qualifying as "distress" terminations are certainly improvements over prior law.

The provisions of SEPPAA also required increases in the PBGC insurance premium paid by employers, long sought by the Administration. It is too early to tell what effect the SEPPAA reforms will have on pension plan funding or the fiscal integrity of the PBGC termination insurance system. However, it is imperative that Congress scrutinize the effect of these reforms before embarking on any structural changes or further premium increases.

FUTURE EXPECTATIONS FOR FUNDING

As the Congress considers the tax reform measure, H.R. 3838, it is considering legislation that could have an impact on future pension plan funding. Regrettably, the impact, if any, will be negative.

Of great concern is the feature of both the House and Senate versions that would impose an excise tax on reversions of excess plan assets following the termination of overfunded pension plans. This is a very unwise policy and contravenes over 48 years of Congressional policy that has encouraged the adequate funding of plans. Companies can only receive a reversion of excess assets after all accrued benefits for both vested and nonvested plan participants are satisfied. Since pension plans always either are overfunded

or underfunded, imposing an excise tax on overfunded plans can only discourage employers from adequately funding their plans. Ironically, such a proposal penalizes those companies that responsibly fund their plans. Similar proposals being developed within the U.S. Department of Labor are also of concern.

Likewise, the provisions of the Senate tax measure that require five-year vesting in pension plans and that force pension plans to cover expanded groups of employees will be costly to those plans -- with a resulting effect on their funding status. Similarly, the reductions in the limits of Section 415 of the Internal Revenue Code, for certain companies' plans, will prevent employers from correctly funding the expected benefits of up to 40 percent of their employees. The Section 415 limits have been lowered a number of times by recent tax legislation. These continual reductions do not bode well for stability and for responsible funding patterns.

Modifying vesting requirements and coverage rules are critical issues of retirement policy and can have a direct impact on pension plan funding. As with the policy on pension reversions and Section 415 limits, these are matters for careful study and should not be considered as appendages to a revision of the Internal Revenue Code. We urge the conferees on the tax reform bill to delete the Senate provisions on vesting, coverage rules, funding limits and pension reversion excise taxes and address all these issues separately as a part of the inquiry into retirement income policy of which this hearing is a part.

CONCLUSION

Responsible funding of pension plans is important to plan participants, the PBGC, the employer community and, ultimately, taxpayers. Policies should encourage the responsible funding of pension plans.

ERISA and recent legislation have had a positive effect on pension plan funding, and the majority of private sector pension plans are adequately funded. However, changes in the law contained in the tax reform measure could have a negative impact on pension plan funding. Instead, these matters should be carefully considered within the context of a thorough study of pension policy. The Chamber is prepared to work closely with the Congress to understand better the reasons for underfunded pension plans and how to improve their funding status.

Statement of

Alan V. Reuther
Associate General Counsel
International Union, UAW

Mr. Chairmen. My name is Alan V. Reuther. I am an Associate General Counsel for the International Union, United Automobile, Aerospace and Agricultural Implement Workers of America (UAW). The UAW appreciates the opportunity to testify before these Subcommittees concerning the funding of single-employer defined benefit pension plans. This subject is of vital concern to the 1.5 million active and retired members of our Union, most of whom are covered under negotiated single-employer defined benefit pension plans.

As the hearing notice makes clear, this hearing is being conducted as part of the comprehensive review of national retirement income policy being undertaken by these Subcommittees at the request of the Chairman of the Ways and Means Committee. We believe this is entirely appropriate. The funding of private pension plans cannot be viewed in isolation; it must be considered in the context of our overall national retirement income policy.

As was indicated in our testimony before these Subcommittees last September, the UAW believes that Social Security must remain the base upon which retirement security is built. However, because Social Security benefits alone fall far short of providing the income necessary to maintain a reasonable standard of living for the great majority of Americans, there is a need for employer-sponsored private pension plans which can provide retirees with additional pension benefits to help supplement Social Security. It is our firm conviction that defined benefit pension plans are the best vehicles for providing, in combination with Social Security benefits, a secure and adequate retirement income to workers and their families.

The UAW is proud of the role it has played in the struggle to achieve adequate funding for defined benefit pension plans. We have been active at the collective bargaining table, as well as in the legislative arena.

In 1950, UAW members struck the Chrysler Corporation to establish the principle that pension plans should be adequately funded. Chrysler wanted to pay pension benefits out of its general treasury, instead of funding them through a trust fund. The UAW insisted that the pension benefits had to be funded in order for the pension promises to be secure. After striking for 104 days, the UAW finally prevailed. The principle that pension benefits should be funded became the standard pattern for UAW negotiated contracts. Through our collective bargaining efforts, we have insisted that employers adequately fund their pension plans.

The UAW was also one of the first organizations to call for the enactment of federal legislation establishing minimum funding standards for all pension plans. We wholeheartedly supported the funding standards that were ultimately included in Title I of the Employee Retirement Income Security Act of 1974 (ERISA). Most UAW collective bargaining agreements already required faster funding than the statutory minimum funding standards. Nevertheless, we recognized that the enactment of minimum funding standards was necessary in order to establish a floor for all pension plans.

In our judgment, the minimum funding standards mandated by ERISA have been a success. They have played an important role in assuring that most pension plans are adequately funded.

However, when Congress enacted ERISA, it recognized that the establishment of minimum funding standards would not be enough to solve the "Studebaker" type of problem which had so shocked the conscience of the nation -- that is, situations in which workers and retirees lost a substantial portion of their vested pension benefits because a company experiencing severe economic difficulty terminated its pension plan and the plan had insufficient assets to pay all vested benefits. To address the "Studebaker" problem, Congress also provided for the establishment of the pension plan termination insurance program in Title IV of ERISA.

The UAW believes that the termination insurance program has been largely successful in achieving its intended objectives. In countless situations, the Pension Benefit Guaranty Corporation (PBGC) has been instrumental in guaranteeing that participants and beneficiaries received at least a portion of anticipated benefits when an economically-troubled company terminated its pension plan and there was insufficient assets to pay all vested benefits.

Some persons have raised questions concerning the termination last year of several pension plans with large unfunded liabilities. The UAW does not believe that these cases should be viewed as evidence that ERISA's minimum funding standards have failed. Rather, these cases should be viewed as vindicating Congress' original judgment that

the establishment of a pension plan termination insurance program was necessary in order to assure that participants and beneficiaries receive anticipated benefits. Thanks to the existence of the PBGC, we were able to prevent a recurrence of the Studebaker pension tragedy in these situations.

To relieve the pressure on the termination insurance program, some persons have suggested that the minimum funding standards ought to be modified to require more rapid funding of pension plans in certain situations. In our judgment, this type of approach could very well prove to be counterproductive. Requiring faster funding at the point a company is experiencing economic difficulty might lead to the quicker demise of the enterprise. This would aggravate the financial condition of the PBGC and undermine the retirement income security of participants and beneficiaries.

The recent enactment of the Single-Employer Pension Plan Amendments Act of 1986 (SEPPAA) has strengthened the termination insurance program, by providing the PBGC with a long overdue premium increase and by closing various loopholes in Title IV. The loopholes had enabled profitable employers to transfer their unfunded pension liabilities to the PBGC and to evade responsibility for the payment of certain nonguaranteed, vested pension benefits. With the important reforms in SEPPAA, we believe the termination insurance program has been placed on a sound basis.

SEPPAA should also have a positive impact on the funding of pension plans. Specifically, to the extent that the PBGC and participants have now been accorded a greater claim against employers for any unfunded pension liabilities, employers will have a greater incentive to provide adequate funding for their plans. Furthermore, by clarifying that the IRS has the authority to require the posting of security as a condition for the granting of a funding waiver, the new law will discourage employers from applying for funding waivers when other alternatives are available for meeting their cash flow problems. Accordingly, the UAW believes that, at a minimum, Congress should wait a reasonable period of time to assess the impact of SEPPAA on the funding of pension plans and the operation of the termination insurance program, before it considers any new legislative initiatives in these areas.

The UAW is convinced that, in the long run, the only effective way to assure adequate funding for defined benefit pension plans and to relieve the pressure on the PBGC is to attack the root causes behind the major plan terminations -- namely, the economic and trade policies which have led to a serious decline in this nation's basic industries. The most salient characteristic of the pension plans with large unfunded liabilities is that their plan sponsors are usually experiencing severe economic difficulty, largely as a result of an overall decline in their industries. The sad truth is that the presence of large unfunded pension liabilities, and the risk that they will be transferred to the termination insurance program because of plan terminations, are simply another facet of the social costs that are generated by these massive economic dislocations.

The problem posed by these large unfunded pension liabilities cannot be solved by tinkering with ERISA's minimum funding standards. It can only be solved by economic and trade policies which will help the plan sponsors return to profitability, so that they can continue to maintain their pension plans and afford to meet their funding obligations. An examination of the Chrysler case history will help to illustrate this fundamental point.

As everyone knows, the Chrysler Corporation was in deep financial trouble in late 1979. Not surprisingly, its pension plan was also in trouble, with assets representing only 27 percent of liabilities (as of January 1, 1980). There was considerable concern that if Chrysler went under and was forced to terminate its pension plan, the solvency of the termination insurance program would be threatened and the retirement income security of millions of workers and retirees would be jeopardized.

Today the situation has changed dramatically. Thanks to the economic assistance provided by the federal government under the Chrysler Loan Guaranty Act and to the sacrifices made by Chrysler workers and retirees, Chrysler has been able to get back on its feet and return to profitability. At the same time, the funding of Chrysler's pension plan has also improved considerably, with assets representing approximately 50 percent of liabilities (as of January 1, 1985). There is now little danger that the pension plan will be terminated and that the PBGC will have to absorb any pension liabilities. Thus, in the end the Chrysler pension problem was solved by the actions of the federal government and the Chrysler workers and retirees which helped to assure the survival of the company.

The Chrysler pension problem could not have been solved by requiring faster funding of the pension plan. Indeed, one of the crucial elements of the economic

assistance package which enabled Chrysler to get back on its feet was the availability of temporary relief from its pension funding obligations. Through negotiations, the UAW allowed Chrysler to delay its scheduled pension contributions until eight and one-half months after the end of the plan year (which is permitted under ERISA's minimum funding standards), instead of making the pension contributions at the end of the plan year (as was required under our collective bargaining agreement). Later, the UAW agreed to allow Chrysler to apply for a funding waiver, provided the waived contribution was repaid on a faster schedule than the minimum required by ERISA. These actions provided Chrysler with additional cash flow of approximately \$200 million, which was essential to its continued operation. If it had not been possible to grant this temporary funding relief to Chrysler -- if instead the company had been required to engage in faster funding at that point in time, the end result might have been the demise of the company and the termination of its pension plan, with devastating consequences for both the plan participants and the PBGC.

Mr. Chairmen, the UAW has appreciated the opportunity to testify before the Subcommittees on Oversight and Social Security concerning the funding of pension plans. We look forward to working with the Members of the Subcommittees as you continue to examine this and other issues associated with the development of a national retirement income policy. Thank you.

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SUBMISSIONS FOR THE RECORD



Pension Benefit Guaranty Corporation
2020 K Street, N.W., Washington, D.C. 20006-1806

Office of the Executive Director

August 27, 1986

The Honorable J. J. Pickle
Chairman
Subcommittee on Oversight
House Ways and Means Committee
1105 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

Enclosed is a statement to supplement my testimony before your Subcommittee at the June 24, 1986, hearing on the underfunding of private pension plans. The statement responds to allegations made at the hearing by Mr. Alan Reuther of the United Auto Workers Union concerning the termination of the Allis-Chalmers pension plan. I would greatly appreciate it if you would include the statement in the hearing record.

I am grateful for your continued interest in the issue of pension plan underfunding and look forward to working with you in the future. Please do not hesitate to contact me if you or your staff have any questions.

Sincerely,

Kathleen P. Utgoff
Kathleen P. Utgoff
Executive Director

Enclosure

DR. KATHLEEN P. UTGOFF
EXECUTIVE DIRECTOR
PENSION BENEFIT GUARANTY CORPORATION

In his testimony before the Subcommittees on Oversight and Social Security of the Committee on Ways and Means on June 24, 1986, Mr. Alan Reuther of the United Auto Workers Union (UAW) made several incorrect statements concerning the Allis-Chalmers pension plan. I would like to address each assertion separately so that the hearing record will reflect the PBGC's views on this issue which is so important to the future of the private pension insurance program.

1. Mr. Reuther stated that it is inaccurate to characterize the depletion of the Allis-Chalmers UAW pension trust as indicative of shortcomings in ERISA's minimum funding standards. He stated that the Allis-Chalmers case and similar cases merely demonstrate the need for PBGC plan termination insurance.

I agree with Mr. Reuther that termination insurance is needed. However, termination insurance should not be a substitute for adequate funding standards. The primary obligation to fund promised benefits must remain with the employer responsible for those promises. That funding obligation should not be deferred until plan termination when the employer is often unable to afford the accumulated cost.

The fact is that the ERISA minimum funding standards do not work well for plans that have a high percentage of retirees and near-retirees. The standards allow funding of pre-ERISA liabilities over 40 years and of post-ERISA benefit improvements over 30 years, regardless of a plan's financial condition or the demographic distribution of the participant base. As a result, benefit payments may begin to exceed contributions. As time goes on, the gap widens so that the plan may run out of money even though it continues to satisfy the legal funding requirements.

That was what happened in the Allis-Chalmers UAW Plan. In 1977, there were only 4,700 active employees compared to 6,500 retired and separated vested participants. The active life population dropped by nearly 1,000 per year in 1977, 1982 and 1983.

From 1977 to 1982, the collective bargaining agreement between the company and the UAW called for larger contributions than those required by the minimum funding standards (30-year rather than 40-year funding of pre-ERISA liabilities and pay-as-you-go rather than slower permissible funding of supplements). Even with the larger contributions, however, benefit payments exceeded contributions, and the unfunded vested benefit liabilities grew. The 1983 collective bargaining agreement allowed the company to pay only the minimum funding amount for the 1982 and subsequent plan years, thus reducing the annual contributions and accelerating the deterioration of the plan.

In 1982, it took over one-third of the plan's assets to pay benefits; yet the minimum funding requirement under ERISA for that year was \$0 because of "credit balances" accumulated from contributions in prior years when the above-minimum levels were required by the collective bargaining agreement. In 1983, the ERISA minimum contribution covered only about one-half of benefit payments, and, as a consequence, plan assets continued to decrease. By the time the plan terminated in July 1985, plan assets would not have been sufficient to pay full benefits to the 8,500 retirees and beneficiaries on September 1, 1985.

I do not think many people would conclude that the ERISA funding standards were successful in the case of the Allis-Chalmers UAW plan. The standards simply did not adequately contemplate the plan's cash flow needs.

2. Mr. Reuther stated that the annual contribution of \$18 million due in September 1985, had it been made, would have enabled the plan to continue to pay benefits through January 1986. He claimed that the PBGC failed to carry out its duties under Title IV of ERISA by not pressing for faster funding and by not enforcing the minimum funding requirements.

Prior to the termination of the plan in July 1985, as stated above, plan assets were not sufficient to pay two more months of benefits to the 8,500 retirees and beneficiaries. If the annual minimum contribution required in September had been paid early, the plan might have been able to make benefit payments until January 1986, another six months. However, company officials told us that they did not have the necessary money and, therefore, did not intend to make the contribution. Moreover, prior to filing for the termination, the company requested a funding waiver from the Internal Revenue Service (IRS) for that contribution.

The PBGC has no authority to enforce the minimum funding standards. The sole governmental authority to enforce such funding requirements resides with the IRS.

Unions and employers may include contribution requirements in their collective bargaining agreements, and a union may sue for breach of the contract when those requirements are not met. The 1983 UAW contract with Allis-Chalmers reduced the previous requirement for contributions greater than the minimum funding standards and provided for contributions to be made only "from time to time" during the term of the agreement and for the company to satisfy the minimum funding standards. The contract also provided for an impartial referee to resolve any pension-related disputes between the union and the company.

In contrast, the UAW's contract with Keystone Consolidated Industries required annual contributions of a specified level to be determined by the company actuary. When Keystone requested a funding waiver for the 1980 plan year minimum contribution, the union sued for payment to enforce an arbitrator's award and won.

3. Mr. Reuther claimed that the PBGC allowed the plan to be terminated prematurely in 1985 in violation of the collective bargaining agreement and that the termination should have been postponed until enactment of the Single Employer Pension Plan Amendments Act of 1985 (SEPPAA).

I agree with Mr. Reuther that there would have been some advantages for the plan's participants, as well as the PBGC, had the plan terminated after SEPPAA was signed into law. SEPPAA gives participants a statutory claim against the employer for unfunded benefits in excess of PBGC guarantees and permits larger employer liability claims for the PBGC. However, it was impossible to predict at that time if or when Congress would approve the legislation. (The bill was eventually signed into law on April 7, 1986, nine months after Allis-Chalmers filed its termination notice.)

More importantly, the dire financial condition of the plan in July 1985 made termination an option which had to be considered immediately. As stated above, at the time of termination, July 1985, the plan had assets to meet less than two months of benefit payments, and the employer was unable to make the contributions needed to pay benefits.

SEPPAA prohibits voluntary termination of a plan under Title IV if the termination would violate a collective bargaining agreement. Even before SEPPAA, a termination could be challenged in court as a contract breach. Such a breach, though, did not halt or invalidate the termination for Title IV purposes; nor did a termination under Title IV relieve a company of the consequences of breaching the contract. The UAW has filed suit in Wisconsin challenging the termination of the Allis-Chalmers UAW plan as a breach of the collective bargaining agreement. There has not yet been any decision in the case.

4. Mr. Reuther stated that Allis-Chalmers should not be used as an example of a company which permitted its liabilities to increase without adequate funding since there were no benefit increases in the plan after 1981.

Although the plan was not amended to improve benefits after 1981, total liabilities and unfunded liabilities continued to increase as employees continued to accrue additional benefits under the plan. Nevertheless, in January 1983, the union agreed to allow the company to reduce contractually required contributions to the minimum required by ERISA.

For the first plan year affected, the contractually required contribution was cut from \$18 million to \$2 million. The reduced contribution requirement exacerbated an already bad situation, and by the time the plan terminated, it had money left for less than two months of benefit payments.

I seriously question whether this situation would have come about if the PBGC guarantees did not exist. The

financial incentive to shift the funding obligation to the PBGC is difficult to resist for a company in trouble and for the union which represents that company's employees.

With our guarantees, in such situations, almost all vested benefits are provided at a bargain price, with the shortfall picked up by the other PBGC premium payers. The money saved by the company is often put to other uses.

Finally, as I stated during the hearing, it is an unfortunate fact that the structure of the PBGC insurance system, with identical premium rates for good and bad risks and with low priority for the PBGC's claims in bankruptcy, encourages the riskiest companies to underfund their plans. In the case of Allis-Chalmers, the underfunding was able to occur even as the company fulfilled the current minimum funding requirements, resulting in the PBGC's second-largest insurance claim in its history.

The minimum funding standards should be reexamined to determine if they indeed fulfill the purpose of adequate plan funding.

The Office of Management and Budget advises that there is no objection to the submission of this statement to the Congress from the standpoint of the Administration's program.

SUPPLEMENTAL STATEMENT TO
THE SUBCOMMITTEES ON OVERSIGHT AND SOCIAL SECURITY
OF THE
HOUSE COMMITTEE ON WAYS AND MEANS
BY NORMAN S. LOSK, CHAIRPERSON
PENSION COMMITTEE
OF THE AMERICAN ACADEMY OF ACTUARIES

HEARING ON NATIONAL RETIREMENT
INCOME POLICY: UNDERFUNDED PENSION PLANS

July 29, 1986

Upon completion of our oral testimony at the June 24, 1986, subcommittee hearing, Chairman Pickle invited us to provide additional comments we might have relative to specific solutions to the current financial problems of the Pension Benefit Guaranty Corporation (PBGC). The purpose of this letter is to provide our general perspective, and perhaps, some portion of a solution to the problem.

I. The Problem

Clearly the PBGC is in financial difficulty. The premiums charged for coverage under this program are simply inadequate to cover the liabilities of the program. Testimony was provided by several witnesses at the hearing indicating that a break-even premium rate is more on the order of \$13.50 per capita rather than the \$8.50 per capita premium currently in place. This testimony was provided before LTV filed for reorganization under Chapter 11 of the bankruptcy code, with a potential liability for PBGC in the range of \$1 billion to \$2 billion.

The underlying problems, however, can be summarized as follows:

- A. The PBGC "insures" the accrued vested benefits of participants in terminating retirement plans, to the extent that they are not funded. The vast majority of terminating plans do so with sufficient assets to cover the accrued vested benefits of their participants. Plans that invoke the insurance tend to be sponsored by companies in substantial financial trouble.
- B. The PBGC's position in bankruptcy proceedings may not be adequate to effect the reimbursement from plan sponsors anticipated by Congress.
- C. The current method of assessing the cost of the insurance program to participating plans is simple but inadequate. At \$1-\$2.65 per participant, the premium was small enough that the premium structure was not a serious problem. Premiums at those levels proved, however, to be inadequate to cover the costs of the insurance program. At \$8.50 per participant (which is, according to other testimony, still inadequate) the premium structure may become burdensome to at least some sponsors.

II. Characteristics of An Appropriate Solution

We believe that a solution to this problem should have certain characteristics:

- A. The PBGC exists to protect plan participants from loss of benefits due to termination of their plan. The plan termination insurance program should not be such that it can be used by failing companies as a cheap means of financing. At the same time, companies which have a chance to survive should not be "pushed over the edge" by the program or by the manner of administration of the funding waiver program.

- B. The solution should not affect the vast majority of plan sponsors who fund their plans adequately and who present no potential risk to the PBGC. Such plan sponsors should neither be penalized for their exercise of such responsibility nor discouraged from continuing the exercise of that responsibility.

III. Possible Solutions

A solution to the problems of the PBGC needs to be both structural and financial. We would suggest that the following combination of changes might satisfy the conditions described above:

- A. Collateralized waivers/bankruptcy priority - While we are not experts in bankruptcy law, a substantial review of this entire area is in order.
- B. Risk related premium - In the pricing of any insurance mechanism, one of the major components is what actuaries call "equity". Equity in a premium structure means fairness. It means that an insured is charged for a risk commensurate with the probability that the risk will occur and the size of the insurance at risk. For example, a driver with a very bad driving record should be charged more than a driver who has never had an accident or a ticket, for the same amount of coverage. Likewise, two identical drivers would be charged different premiums if the dollar limits of their policies differed.

If this basic fairness is not built into an insurance mechanism the result is that the good risks subsidize the poor ones. A natural implication of this in a free enterprise setting is that a good risk will either go elsewhere for the insurance or will not buy the insurance, while the bad risks continue with the insurance. As a result the amount required to cover the losses grows rapidly because only the poor risks remain within the insured pool.

The PBGC's termination insurance programs are mandatory; virtually every retirement plan of any size must participate in this program by law. However, employers are not required to sponsor pension plans. The increasingly burdensome, uncertain, and rapidly changing federal regulations of private pension plans and new accounting requirements of the Financial Accounting Standards Board have combined to create a negative environment in which defined benefit plans operate. Large numbers of plans have terminated over the last few years with very few new plans forming. The increase in the PBGC premium rate from \$2.65 per capita to \$8.50 is just one more disincentive for the creation or maintenance of defined benefit pension plans.

The large majority of the plans that have terminated in recent years have had assets sufficient to cover the benefits of their vested members. Thus, decisions are being made to avoid participation in the PBGC's insurance by plan termination. A \$13.50 or more per capita premium would certainly add to this burden.

On the other hand, a risk related premium would allocate the cost of the program more fairly in the direction of those plans likely to terminate with insufficient assets. Such a structure would encourage responsible funding of retirement plans while penalizing the opposite behavior.

The administrative details of such a structure would contain certain problems. A truly risk related premium structure would be based upon:

- (1) the size of the unfunded actuarial present value of increased vested benefits,
- (2) the economic viability of the underlying plan sponsor, and

- (3) the economic viability of the industry in which the plan sponsor operates.

Any complete assessment of the risk of plan termination must include an assessment of the economic viability of the plan sponsor. Future financing of a plan depends on that viability. However, there are important implications regarding a federal agency's assessing the economic viability of a private enterprise and publishing the results of the assessment.

In addition, a true risk-related premium structure would assess no premium to a plan during a year in which it has no chance of terminating with insufficient assets. If there is no assessment of economic viability of the underlying sponsor, this must be defined as a year in which the assets of the plan equal or exceed the actuarial present value of insured benefits.

However, it is possible that if no premium were assessed against such plans, the cost of the termination insurance program would be overly burdensome to those who remain, particularly if they already have financial difficulty. Thus, some subsidy from well funded plans may be required. This would lead to development of a premium structure that would assess cost based on a formula such as:

- $x\%$ of unfunded actuarial present value of insured vested benefits, but with a minimum charge based on a formula such as:
- \$ y per participant.

The variables " x " and " y " can be established based on a review of the appropriate statistics. However, we suggest that " y " be set at a level below that of the current \$8.50 level.

- C. Minimum Funding Standards - It has been suggested that the minimum funding standards be amended so that the cost of pension benefits be amortized more rapidly. Again, we believe that the problem of termination of underfunded retirement plans is one which involves only a small minority of plans. The vast majority of those plans terminating do so with excess assets. Thus, in the majority of cases the minimum funding standards are working.

The one area in which minimum funding standards may be improved relates to plans that do not have sufficient assets to cover the benefits being paid or to be paid to retired and vested terminated participants.

As has been stated previously, there are a number of actuarial funding methods used within the structure of the minimum funding standards. However, the goal of each of these methods is to generate sufficient assets during the working careers of active participants so that by the time such participants retire or otherwise terminate, sufficient assets will have accumulated to support their benefits. That is, theoretically, no additional contributions should need to be made with respect to inactive participants.

There may, however, be plans in the United States that do not have sufficient assets to cover the actuarial present value of their benefits to inactive participants. We believe that the unfunded actuarial present value of benefits to current retirees and vested terminated participants should be amortized over a very short period of time, such as ten years. This is the only area in which changes can reasonably be made to the minimum funding requirements—overall, they work well.

The Academy appreciates the opportunity to provide these comments to the Subcommittees on Oversight and Social Security. We hope to continue to work with members and staff of the subcommittees on all issues relating to national retirement income policy.